S. Hrg. 99-246, Pt. XXI

TAX REFORM PROPOSALS—XXI

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

SEPTEMBER 26, 1985

(Financial Institutions and the Mining Industry)

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE
56-330 O WASHINGTON : 1986

5361-53

COMMITTEE ON FINANCE

BOB PACKWOOD, Oregon, *Chairman*

ROBERT J. DOLE, Kansas
WILLIAM V. ROTH, Jr., Delaware
JOHN C. DANFORTH, Missouri
JOHN H. CHAFEE, Rhode Island
JOHN HEINZ, Pennsylvania
MALCOLM WALLOP, Wyoming
DAVID DURENBERGER, Minnesota
WILLIAM L. ARMSTRONG, Colorado
STEVEN D. SYMMS, Idaho
CHARLES E. GRASSLEY, Iowa

RUSSELL B. LONG, Louisiana
LLOYD BENTSEN, Texas
SPARK M. MATSUNAGA, Hawaii
DANIEL PATRICK MOYNIHAN, New York
MAX BAUCUS, Montana
DAVID L. BOREN, Oklahoma
BILL BRADLEY, New Jersey
GEORGE J. MITCHELL, Maine
DAVID PRYOR, Arkansas

William Diefenderfer, *Chief of Staff*
Michael Stern, *Staff Director*

CONTENTS

PUBLIC WITNESSES

Page
American Bankers Association, Mark N. Olson, president-elect 47
American Iron Ore Association, John L. Kelley, chairman, tax committee 210
American Mining Congress, Dennis P. Bedell, chairman, tax committee 226
Bedell, Dennis P., chairman, tax committee, American Mining Congress 226
Beneficial Corp., Finn M.W. Caspersen, chairman of the board 59
California League of Savings Institutions, W. Dean Cannon, Jr., president 84
Cannon, W. Dean, Jr., president, California League of Savings Institutions 84
Caspersen, Finn M.W., chairman of the board, Beneficial Corp 59
Kelley, John L., chairman, tax committee, American Iron Ore Association 210
Leisenring, E.B., Jr., chairman, Westmoreland Coal Co. on behalf of the National Coal Association 190
Minneapolis Federal Employees Credit Union, Joseph Perkowski, president 113
Morris, Joe, president, Columbia Savings Association on behalf of the U.S. League of Savings Institutions 70
National Building Granite Quarries Association, Kurt Swenson, president 250
National Coal Association, E.B. Leisenring, Jr 190
Olson, Mark N., president-elect, American Bankers Association 47
Perkowski, Joseph, president, Minneapolis Federal Employees Credit Union 113
Swenson, Kurt, president, National Building Granite Quarries Association 250
U.S. League of Savings Institutions, Joe Morris 70

ADDITIONAL INFORMATION

Committee press release 1
Background material by the Joint Committee on Taxation 2
Prepared statement of Mark N. Olson 48
Prepared statement of Finn M.W. Caspersen 61
Prepared statement of Joe C. Morris 71
Prepared statement of W. Dean Cannon, Jr 87
Prepared statement of Joseph Perkowski 115
Staff paper by U.S. League of Savings Institutions 156
Prepared statement of E.B. Leisenring, Jr 193
Prepared statement of John L. Kelley 212
Prepared statement of Dennis P. Bedell 228
Prepared statement of the National Building Granite Quarries Association 251
Prepared statement of Kurt Swenson 275
Letters to Senator Symms from the Hecla Mining Co 291

COMMUNICATIONS

Deloitte Haskins & Sells 295
Expanded Shale, Clay and Slate Institute 303
McGlinchey, Stafford, Mintz, Cellini and Lang 309
Mining & Reclamation Council of America 318
National Association of Federal Credit Unions 328
National Council of Coal Lessors, Inc 353
National Council of Savings Institutions 366
National Federation of Community Development Credit Unions 377
National Stone Association 383
Western Coal Traffic League 391

THE IMPACT OF TAX REFORM ON FINANCIAL INSTITUTIONS AND THE MINING INDUSTRY

THURSDAY, SEPTEMBER 26, 1985

U.S. Senate,
Committee on Finance,
Washington, DC.

The committee met, pursuant to notice, at 9:30 a.m. in room SD-215, Dirksen Senate Office Building, Hon. Bob Packwood (chairman) presiding.

Present: Senators Packwood, Chafee, Durenberger, Symms, Grassley, Long, Bentsen, Baucus, and Bradley.

[The press release announcing the hearing and background material on taxing of financial institutions follow:]

[Press Release No. 85-068 August 9, 1985]

Tax Reform Hearing Before the Finance Committee to Continue in September and October

Further hearings before the Senate Committee on Finance on the President's tax reform proposal will continue in September and October, Chairman Bob Packwood (R-Oregon) announced today.

"The Committee made significant progress in its tax reform hearing schedule in June and July," Senator Packwood stated. "Although the Committee will focus much of its attention on deficit reduction in the month of September, tax reform hearings will continue and will take us further toward our goal of getting a tax reform bill to the President before the end of this session of Congress."

The hearings announced by Senator Packwood today include:

On Tuesday, September 24, the Committee will hear from public witnesses on the impact of tax reform on tax-exempt bonds.

On Thursday, September 26, public witnesses will present their views on the impact of the President's tax reform proposal on financial institutions and on the mining industry.

On Tuesday, October 1, the Committee will receive testimony on the impact of the tax plan on the insurance industry.

On Wednesday, October 2, witnesses representing the public will present testimony on the projected effect that tax reform will have on American business generally and, in addition, its impact on the foreign tax provisions.

On Thursday, October 3, the Committee will consider the views of public witnesses on the impact of the President's tax reform proposal on our nation's regulated industries, as well as those provisions relating to the United States' possessions and its territories.

All of the hearings scheduled by the Committee will begin at 9:30 a.m. in Room SD-215 of the Dirksen Senate Office Building.

TAX REFORM PROPOSALS:
TAXATION OF FINANCIAL INSTITUTIONS

FOR THE USE
OF THE
COMMITTEE ON WAYS AND MEANS
AND THE
COMMITTEE ON FINANCE

PREPARED BY THE STAFF
OF THE
JOINT COMMITTEE ON TAXATION

INTRODUCTION

This pamphlet[1] is prepared by the staff of the Joint Committee on Taxation for the House Committee on Ways and Means and the Senate Committee on Finance in connection with the respective committee review of comprehensive tax reform proposals. This pamphlet is one of a series of tax reform proposal pamphlets, and it describes and analyzes tax provisions and proposals relating to the taxation of financial institutions.

The pamphlet describes present-law tax provisions and the tax reform proposal made by President Reagan ("The President's Proposals to the Congress for Fairness, Growth, and Simplicity," May 1985, referred to as the "Administration proposal"), the 1984 Treasury Department recommendations to the President ("Tax Reform for Fairness, Simplicity, and Economic Growth," November 1984, referred to as the "1984 Treasury report"), Congressional proposals (identified by the primary sponsors), and other related proposals.

The first part of the pamphlet is an overview. The second part discusses specific provisions relating to the taxation of financial institutions, including a description of present law and the changes proposed by the Administration, the 1984 Treasury report, and Congressional members.

---

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Tax Reform Proposals: Taxation of Financial Institutions* (JCS-38-85), September 12, 1985.

I. OVERVIEW

Reserves for bad debts

Commercial banks.—Under present law, a commercial bank is permitted a deduction for a reasonable addition to a reserve for bad debts. The reasonable addition to the reserve is defined as the amount necessary to increase the reserve balance to a dollar amount computed under the experience method or the percentage of eligible loan method. Under the experience method, the addition to the reserve is the amount necessary to increase the reserve balance an amount equal to the rate of the taxpayer's average bad debt experience for that year and the previous five years times the loans outstanding at the end of the taxable year. Under the percentage of eligible loan method, the addition to the reserve is the amount necessary to increase the reserve balance to a statutorily set percentage of the outstanding eligible loans as of the end of the taxable year. The current percentage is 0.6 percent. The percentage of eligible loan method is scheduled to expire for taxable years after 1987.

Thrift institutions.—Under present law, a thrift institution (i.e., a building and loan association, mutual savings bank, or cooperative bank) also is permitted a deduction for a reasonable addition to a reserve for bad debts. In addition to either the experience method or the percentage of eligible loan methods, thrift institutions are allowed a deduction equal to 40 percent of the otherwise taxable income so long as a specified percentage of their assets are invested in qualified assets (including home mortgages).

In the case of both commercial banks and thrift institutions, 20 percent of bad debt deductions in excess of those computed using the experience method is disallowed. In addition, banks and thrift institutions are allowed a 10-year net operating loss carryback and a 5 year carryforward (as opposed to the normal rule of a 3-year carryback and a 15-year carryforward).

The Administration proposal would prohibit deductions for additions to a reserve for bad debts for all taxpayers, including commercial banks and thrift institutions, and allow deductions for bad debts as they occur. As a result, the 20-percent disallowance rule of present law for excess bad debt deductions would be repealed. The Administration proposal also would provide commercial banks and thrift institutions with the same net operating loss carryover rules as other taxpayers (i.e., a 3-year carryback and a 15-year carryforward).

Interest on debt used to carry tax-exempt bonds

Present law disallows the deduction of interest payments on indebtedness incurred to purchase or carry tax-exempt obligations. Under a long-standing judicial and administrative interpretation, financial institution deposits generally are not considered to have been accepted for the purpose of acquiring or holding tax-exempt obligations. Thus, a bank or other financial institution may invest deposited funds in tax-exempt obligations, while continuing to receive a deduction for interest paid to depositors. This contrasts with the treatment of individuals and most non-banking corporations, who are denied an interest deduction to the extent they use borrowed funds to acquire or hold tax-exempts.

The rules regarding corporate preference items (sec. 291), added in 1982, reduce by 20 percent the amount of the otherwise allowable deduction by financial institutions for interest on debt allocable to tax-exempt obligations acquired after 1982. This 20 percent reduction is applied to that portion of the financial institution's interest deduction which is equivalent to the portion of the institution's assets which is invested in tax-exempt obligations. For example, a financial institution that invests 25 percent of its assets in tax-exempt obligations is denied 5 percent (20 percent) of its otherwise allowable interest deduction.

The Administration proposal would deny financial institutions 100 percent of interest deductions that are allocable to tax-exempt obligations acquired on or after January 1, 1986. The amount of interest allocable to tax-exempt obligations would be determined in the same manner as under present law. For example, a financial institution which invests one-third of its assets in tax-exempt obligations would be denied one-third of its otherwise allowable deduction. The present law (i.e., 20 percent) reduction rule would continue to apply with respect to tax-exempt obligations acquired after 1982 and before 1986.

Special rules for reorganizations of financially-troubled thrift institutions

Tax-free reorganization status.—Under present law, in order for a merger or other combination of corporations to be completed on a tax-free basis a significant portion of the shareholders of the combined corporations before the combination must be shareholders after the combination. Present law also provides special rules in the case of financially-troubled thrift institutions under which this test is deemed to be met if substantially all of the depositors of the financially-troubled thrift institution are depositors in the combined corporations after the combination.

The Administration proposal would repeal this special treatment effective after 1990.

Net-operating loss deduction.—Under present law, in order for a successor to a combination of corporations to use the net operating loss deductions of the predecessor corporations, a significant portion of the shareholders of the loss corporations have to be shareholders in the successor corporation. Present law provides a special rule in the case of financially-troubled thrift institutions under which this rule is deemed met if substantially all of the depositors of the loss corporations are depositors of the successor corporation after the combination.

The Administration proposal would repeal this special treatment effective after 1990.

Tax treatment of FSLIC contributions.—Present law provides that contributions by the Federal Savings and Loan Insurance Corporation to financially-troubled building and loan associations or cooperative banks are not includible in income nor do they reduce the basis of any asset.

The Administration proposal would repeal this special treatment for contributions made after 1990, unless made pursuant to a contract to make contributions entered into before 1991.

Credit unions

Under present law, credit unions (including both Federal and State chartered credit unions) are exempt from Federal income tax.

The Administration proposal would repeal the tax exemption for credit unions having assets of $5 million or more, effective for taxable years beginning on or after January 1, 1986. Taxable credit unions would be subject to the same tax rules (including bad debt treatment) as would apply to thrift institutions.

II. SPECIFIC PROPOSALS AND PROVISIONS

A. Reserves for Bad Debts

1. Commercial Banks

Present Law

Under present law, commercial banks[2] are allowed to use either the specific charge-off method or the reserve method in accounting for their bad debts for Federal income tax purposes. Under the reserve method, a bad debt deduction is allowed for the amount necessary to maintain a year-end bad debt reserve balance equal to an amount computed under either the "experience" or the "percentage of eligible loans" methods.[3]

Specific charge-off method

The specific chargeoff method recognizes an expense for bad debts only as they actually become either wholly or partially worthless. All amounts receivable are recorded at their full face value.[4] At such time as a receivable is determined to be uncollectible in whole or in part, the receivable is reduced by the amount of uncollectibility, and an expense is recognized in an equal amount. If an amount previously charged-off as uncollectible is later recovered, the recovery is treated as a separate income item at the time of collection. Wholly worthless amounts are charged-off as a bad debt deduction for Federal income tax purposes in the year in which they become worthless. Partially worthless amounts not only must have become partially worthless for Federal income tax purposes, but must also be charged-off on the taxpayer's books in the amount of such partial worthlessness before a bad debt deduction is allowed for tax purposes.

---

[2] The bad debt provisions discussed herein apply to domestic and foreign corporations, a substantial portion of whose business consists or receiving deposits and making loans and discounts, or of exercising fiduciary powers similar to those permitted national banks, and who are subject by law to supervision and examination by State or Federal authority having supervision over banking institutions. Domestic building and loan associations, mutual savings banks or cooperative nonprofit mutual banks are not included in the definition of commercial bank for this purpose.

[3] Code sec. 585.

[4] Receivables of banks include the principal amount of loans for both cash and accrual method banks. Accrued but unpaid items, including interest and fees, are included in the receivables of accrual method banks, but not in the receivables of cash method banks. Under present law, banks may report for Federal income tax purposes under either the accrual or cash method. However, the Administration proposal would restrict the use of the cash method for larger taxpayers and those currently using methods other than cash for purposes other than tax. See discussion of the cash method in Joint Committee on Taxation, *Tax Reform Proposals: Accounting Issues* (JCS-39-85), September, 1985, Part II. A.

Reserve method

In general.—The reserve method records receivables at their full face value. However, unlike the specific charge-off method, a reserve account is set up as an allowance against the eventuality that some of the receivables may eventually prove to be uncollectible. The actual deduction for bad debts for any year is the amount which is necessary to bring the beginning bad debt reserve, adjusted for actual bad debts and recoveries during the year, to the allowed ending balance computed under one of the approved methods.[5] Thus, amounts specifically charged off or recovered are not items of expense or income per se, but are integral components of the computation of the deductible addition to the reserve.

The results obtained under the reserve method will differ from results obtained under the specific charge-off method if ending reserve balances change from year to year. Where the beginning and ending reserve balances are the same, both methods yield the same net deductible amount. Any increase in the ending reserve balance as compared to the beginning balance will yield a higher deduction under the reserve method, while any decrease will yield a lower deduction. For an ongoing entity, the sum of deductions claimed for all years under the reserve method will exceed the sum of deductions claimed under the specific charge-off method as long as there is a positive bad debt reserve balance in existence at year end.

Experience method.—Under the "experience method," the maximum reserve for bad debts is equal to the amount of outstanding loans which are expected to be uncollectable within the next year. This amount is determined by dividing the total bad debts in the current and five preceding taxable years by the sum of the loans outstanding at the close of each of those years and then multiplying that rate by the amount of outstanding loans. However, the ending reserve balance need not be reduced to an amount less than the balance in the reserve at the close of a statutorially determined base year, so long as total loans outstanding at the close of the current taxable year are at least as great as loans outstanding at the close of the base year. If loans outstanding at the close of the current year are less than loans outstanding at the close of the base year, then the minimum reserve under this alternative is limited to a proportionate part of the base year reserve which bears the same ratio as the ratio of loans at the close of the current year bears to loans at the close of the base year. The base year is the last taxable year before the most recent adoption of the experience method.

Taxpayers may use an averaging period shorter than 6 years with the approval of the Treasury. Treasury has indicated by regulations that a period shorter than 6 years will be appropriate only "where there is a change in the type of a substantial portion of the loans outstanding such that the risk of loss is substantially increased."[6] The computation must be based on actual experience during the averaging period. Other evidence indicating a future change in loss experience may not be used except to reduce the averaging period.

---

[5] The actual formula is beginning reserve minus actual worthless debts experienced during the year plus actual recoveries during the year plus deductible addition to reserve equals ending reserve. The formula is solved for the deductible addition after all the other amounts are determined.

[6] Treas. Regs. sec. 1.585-2(c)(1)(ii).

Percentage of eligible loans method.—Under the percentage of eligible loans method, the loan loss reserve at the close of the taxable year is equal to a statutorially specified percentage of outstanding eligible loans at the close of the taxable year, plus an amount determined under the experience method for ineligible loans. The specified percentage for tax years beginning after 1982 is 0.6 percent. For tax years beginning after 1975 but before 1982, the specified percentage, was 1.2 percent. For tax years beginning in 1982, the specified percentage was 1.0 percent. Eligible loans for this purpose generally are loans incurred in the course of a bank's normal customer loan activities on which there is more than an insubstantial risk of loss.[7]

As is the case under the experience method, commercial banks utilizing the percentage of eligible loans method are permitted, at a minimum, a balance in the loan loss reserve at the close of the taxable year equal to a base-year level so long as eligible loans have not decreased from their level in the base year. For tax years beginning after 1982, the base year is the last tax year beginning before 1983 (the last year before the rate was dropped to 0.6 percent). If eligible loans have decreased below their base-year level, the minimum bad debt reserve permitted the bank will be reduced proportionately.[8] In addition, the maximum addition for any taxable year to the reserve for losses on loans under the percentage method cannot exceed the greater of either 0.6 percent of eligible loans outstanding at the close of the taxable year or an amount sufficient to increase the reserve for losses on loans to 0.6 percent of eligible loans at such time.

A commercial bank may switch between reserve methods from one year to another. A commercial bank need not adopt a method yielding the largest deduction, although the regulations do prescribe minimum deductions.

Under present law, if the bad debt reserve deduction for the taxable year determined under the above rules exceeds the amount which would have been allowed as a deduction on the basis of actual experience, the deduction is reduced by 20 percent of such excess (sec. 291). Also, 59-5/6 percent of the deductible excess (after the 20-percent reduction) is treated as a tax preference for purposes of computing the corporate minimum tax (sec. 57).

The availability of the percentage of eligible loans method is scheduled to expire for taxable years beginning after 1987. For taxable years beginning after 1987, banks will be limited to the experience method in computing additions to bad debt reserves. At that time, the base year for computation under the experience method will become the last taxable year beginning before 1988.

---

[7] Specifically excluded from the definition of an eligible loan are a loan to a bank; a loan to a domestic branch of a foreign corporation which would be a bank were it not a foreign corporation; a loan secured by a deposit in the lending bank or in another bank if the taxpayer bank has control over the withdrawal of such deposit; a loan to or guaranteed by, the United States, a possession or instrumentality thereof, or to a State or political subdivision thereof; a loan evidenced by a security; a loan of Federal funds; and commercial paper.

[8] There is a further limitation that reduces the bad debt addition under the base year method when the base year loss reserve is less than the the allowable percentage of base year loans.

Determination of worthlessness

The determination of whether a debt is worthless in whole or in part generally is the same for both the computation of deductions under the specific charge-off method and adjustments to the reserve balance made under the reserve method. Worthlessness is a question of fact, to be determined by considering all pertinent evidence, including the value of any collateral securing the obligation and the financial condition of the debtor.[9] A debt is not worthless merely because its collection is in doubt. So long as there is a reasonable expectation that it eventually may be paid, the debt is not to be considered worthless. Wholly worthless debts may be charged off for Federal income tax purposes only in the year they become worthless, and not in some later year when the fact of worthlessness is confirmed. Partially worthless debts must be charged-off on the taxpayer's books in order to be charged-off for Federal income tax purposes. Thus, the charge-off of a partially worthless debt for Federal income tax purposes occurs in the later of the year in which the debt becomes partially worthless or is charged-off on the taxpayer's books. However, the charge-off for Federal income tax purposes cannot occur any later than the year in which the partially worthless debt becomes wholly worthless.

Among the factors which may be considered in determining worthlessness are bankruptcy of the debtor, termination of the debtor's business, the debtor's death or disappearance, receivership of the debtor, and a decline in the value of collateral available to satisfy the debt. None of these factors is in and of itself determinitive, however, and a finding of worthlessness must be predicated on an objective test of all facts and circumstances.[10] Thus, the entering of a debtor into bankruptcy does not by itself establish worthlessness. However, if the surrounding facts and circumstances indicate only a de minimis chance of recovery, a debt may be treated as worthless at that time.[11]

A debt is not worthless merely because it has no current liquidating value if there is a reasonable expectation that it may acquire value in the future. A business debtor may be able to satisfy its obligations out of future activities, despite the fact that it is technically insolvent at the present time. An individual, although currently insolvent, may generate future income that could pay off the debt. Where these expectations are reasonable, the debt is not worthless.

A creditor must normally take all reasonable steps necessary to collect a debt, including legal action if necessary, before it will be held to be worthless. However, where the surrounding circumstances indicate that a debt is worthless and uncollectible and the legal action would in all probability not result in satisfaction, a showing of such facts will suffice, and legal action need not actually be brought.[12] The fact that the debtor refuses to pay or the creditor makes a business decision not to pursue the debtor does not support a charge-off for Federal income tax purposes. The running of any applicable statute of limitations is not conclusive in establishing that a debt has become worthless, unless it is clear that the debtor would avail himself of that defense.[13]

---

[9] Treas. Regs. sec. 1.166-2(a).

[10] *Denver and Rio Grande Western Railroad Co. v. Comm'r*, 279 F. 2d 368 (10th Cir., 1960).

[11] Rev. Rul. 71-577, 1971-2 C.B. 129. Allowed a charge-off of a wholly worthless bad debt where the receiver in bankruptcy notified creditors that, following liquidation, at most one or two cents on the dollar would be available.

For banks and other financial institutions regulated by Federal or State authorities, worthlessness may be presumed for any debts charged off in obedience to specific orders of such authorities. Also, if the institution has previously charged-off a debt as worthless, and the regulatory authorities confirm in writing that they would have ordered such charge-off if they had audited the institutions books on the date of the charge-off, the presumption will apply.[14]

Background

Legislative history

Since 1921, banks have been allowed to establish reserves for bad debts for Federal income tax purposes. Originally, the bad debt reserve was determined in the same manner as for any other taxpayer.

In 1947, the Internal Revenue Service issued Mimeograph 6209 (1947-2, C.B. 26) which provided that a bank was to be allowed to compute its experience bad debt rate using a 20-year moving average rule. The effect of the mimeograph was to allow consideration of bad debt experience during the Depression in determining the portion of outstanding loans could be expected to become uncollectible and thus includible as a component of the tax reserve. In 1954, the Internal Revenue Service issued Rev. Rul. 54-198 (1954-1, C.B. 60) which provided that an experience type bad debt reserve could be computed using any continuous 20-year period since 1928, or the experience of similar banks for such a period. The effect of Rev. Rul. 54-198 was to allow banks to permanently use their experience during the Depression to compute their bad debt reserves for Federal income tax purposes. At this time, no method comparable to the present percentage of loans method was allowed.

In 1965, the first percentage of loans method was allowed by the Treasury. In Rev. Rul. 65-92 (1965-1, C.B. 112), a uniform reserve ratio equal to 2.4 percent of loans outstanding (other than government-guaranteed loans) was established as a replacement for the special twenty-year period of the earlier rulings. A bank was still allowed to use the experience method, but the experience to be considered was limited to the current and 5 preceding tax years. Special rules were provided which limited the increase to the reserve in any one year and which generally preserved higher reserve levels already in existence using a base year approach similar to present law. In allowing a uniform reserve ratio based on a percentage of loans outstanding, the Internal Revenue Service indicated that it was attempting to address the problem of large variances in the bad debt reserves of various banks for Federal income tax purposes and also the problem of allowing reserve ceilings which were not related to the probability of bad debts occurring on outstanding loans. However, it has been suggested that the 2.4 percent rate was approximately 3 times the annual rate of bad debt losses of commercial banks during the period from 1928 to 1947, the twenty year period which was most likely to have been used under Rev. Rul. 54-148. In 1968, eligibility for the 2.4-percent rate was limited to loans which were considered not to be sufficiently at risk to justify the use of the standard percentage of loans rate.[15]

---

[12] Treas. Regs. sec. 1.166-2(b).

[13] *Suman v. Commissioner*, 26 T.C.M. 420 (1967).

[14] (Treas. Regs. sec. 1.166-2(d).)

The Tax Reform Act of 1969 established the statutory basis for the present system of computing bad debts for commercial banks. In the main, this was a codification of the approach developed under the administrative rulings, combined with a phaseout of the percentage of eligible loans method over an 18-year period. The percentage for years beginning after July 11, 1969 and before 1976 was reduced to 1.8 percent. For the period of 1976-1981, a 1.2 percent rate was allowed, and the present 0.6 percent rate established for years between 1982 and 1987. For taxable years beginning after 1987, the percentage of eligible loans method will be completely phased out.

The Tax Reform Act of 1969 also provided that the excess of the bad debt deduction of a financial institution (including a bank) over the bad debt deduction which would have been allowed under the experience method is an item of tax preference for purposes of the corporate minimum tax.

The Economic Recovery Tax Act of 1981 delayed the reduction in the percentage rate to 0.6 percent by one year, from 1982 to 1983, and established an intermediate rate of one percent for 1982. The 1982 tax year was established as the base year for all later years, unless a method other than percentage of eligible loans was used to compute the bad debt reserves after that time.

The Tax Equity and Fiscal Responsibility Act of 1982 reduced the bad debt reserve deduction of banks using the percentage of eligible loans method by 15 percent of the excess of the deduction under that method over the deduction which would have been allowed under the experience method. This reduction was part of an across-the-board cutback in tax preferences. Concurrently, the portion of actual deduction in excess of experience method constituting a tax preference for the minimum tax was reduced to 71.6 percent.[16] The Deficit Reduction Act of 1984 increased the cutback of excess bad debt deductions to 20 percent and decreased the minimum tax preference inclusion rate to 59-5/6 percent.

---

[15] Generally, these excluded loans are interbank deposits and loans, loans for which cash collateral is held (not including compensating balance arrangements), unearned discounts or interest receivable included in face amount of loans, debt securities, and "money market" investments (Federal funds and commercial paper) in addition to the government guaranteed loans which were excepted under Rev. Rul. 65-92.

[16] The 71.6 percent figure is the amount needed to prevent the combination of the corporate minimum tax and the 15-percent reduction in the deduction from reducing the tax benefit from a marginal tax dollar of preference by more than it was cutback by the corporate minimum tax prior to the passage of the 15-percent cutback for a taxpayer at the 46-percent marginal tax rate, with over $10,000 of regular tax and tax preferences in excess of regular tax liability. See, Joint Committee on Taxation, *General Explanation of the Tax Equity and Fiscal Responsibility Act of 1982* (P.L. 97-248) (JCS-38-82), December 31, 1982.

Financial and regulatory accounting

The financial accounting of banks must be done in accordance with generally accepted accounting principles (GAAP). For financial accounting purposes, a reserve method would be required in almost all instances. The specific charge-off method would not be allowed. Statement of Financial Accounting Standards No. 5[17] requires that a contingency account be established whenever it is probable that an asset has been impaired and the amount of the loss can be reasonably estimated. As to receivables, FAS 5 provides that, where it is probable that an enterprise will be unable to collect all of its receivables, its receivable asset has been impaired. In cases where the potential amount of loss can be reasonably estimated, the liability for the loss contingency should be recorded currently.

In practice, a financial accountant will generally stratify outstanding receivables into a number of classes based both on the type of receivable (consumer loans, business demand loans, home mortgages, etc.) and on a subjective determination of the risk the receivable will not be repaid. In making the risk determination, such factors as available cash flow and underlying value of the debtor, current value of any collateral securing the receivable, and timeliness of interest payments will be considered. After the stratification is completed, different bad debt rates will be applied to each class in order to establish the reserve for bad debt losses required for that class. The rate used for each class should take into consideration all relevant conditions existing at the date of the balance sheet. These considerations include previous collection experience as well as estimates of the effect of changing business trends and other environmental conditions. "Mechanical forumulas that incorporate only collection experience should not be overemphasized."[18] The ending bad debt reserve for the bank will be the sum of the reserves computed for each separate class.

For financial accounting purposes, the balance in the reserve for bad debts is the expected impairment of the value of a bank's receivables, whenever that impairment will occur. For Federal income tax accounting purposes, the balance in the reserve for bad debts, determined under the experience method, is the expected impairment of the value of a bank's receivables which will occur in the following year. For Federal income tax accounting purposes, the balance in the reserve for bad debts determined under the percentage of eligible loans method is not determined with regard to any expected impairment of the value of a bank's receivables.

Regulatory accounting generally follows financial accounting under generally accepted accounting principles (GAAP) with respect to the recording of bad debt reserves. However, due to the subjective nature of determining the bad debt reserve under GAAP the reserve requirements for regulatory and financial purposes may not always be identical.

---

[17] Hereinafter referred to as ("FAS 5").

[18] American Institute of Certified Public Accountants, *Audits of Banks*, (1983), p. 62.

Administration Proposal

The Administration proposal would repeal the use of both the experience and percentage of eligible loan methods for commercial banks, effective for tax years beginning on or after January 1, 1986. Under the Administration proposal, deductions for bad debts would be allowed when the loans are partially or wholly worthless (i.e., the specific charge-off method would be used). The existing balance in the reserve for bad debts as of the effective date would be included in income (recaptured) ratably over a 10-year period, starting with the first taxable year beginning on or after January 1, 1986. This would place commercial banks on the same footing as other taxpayers. A special alternative would allow commercial banks to elect to include the entire balance in the reserve in income in the first taxable year beginning on or after January 1, 1986.

Other Proposals

1984 Treasury Report

The 1984 Treasury report generally provides for the same treatment as the Administration proposal other than the election to include the existing reserve balance immediately rather than over 10 years.

S. 409 and H.R. 800 (Bradley-Gephardt)

The Bradley-Gephardt bill would repeal the percentage of eligible loans method effective for tax years beginning after December 31, 1986. The experience method would be retained.

H.R. 2222 and S. 1006 (Kemp-Kasten)

The Kemp-Kasten bill would repeal the percentage of eligible loans methods effective for tax years beginning after December 31, 1986. The experience method would be retained.

S. 1263 (Roth) and H.R. 2874 (Flippo-Frenzel)

The bill would require that bad debt reserves for tax be conformed to the bad debt reserve maintained for financial statement purposes, up to a maximum bad debt reserve of 1.5 percent of total loans. The greatest tax deduction in any one year would be limited to 0.5 percent of total loans of the taxpayer at the end of that year. Any initial increase in the tax reserve due to the conformity requirement would be spread over 6 years. The changes would apply with respect to taxable years beginning after 1984.

Analysis

Overview

Taxpayers generally are not allowed to deduct future liabilities or expenses until the event giving rise to the liability or expense occurs. In the case of loans, the Federal income tax laws since 1921 have allowed taxpayers to deduct additions to bad debt reserves; that is, to accumulate a bad debt reserve out of pre-tax, rather than after-tax, income. Absent the special provisions for bad debt reserves, taxpayers would not be allowed to deduct a loan loss until the loan is determined to be wholly or partially worthless. The main issue is whether the reserve method of accounting for bad debts more accurately measures the economic income of lenders than the specific charge-off method that would be required by the Administration proposal. A related issue is the extent to which accrual accounting principles would require a bad debt reserve for lenders that use the accrual method of accounting for Federal income tax purposes. A third issue is the tax treatment of accumulated bad debt reserves on existing loans under the Administration proposal.

Income measurement

Financial and regulatory accounting

Banks that file financial statements with the Securities and Exchange Commission are required to prepare these statements in accordance with generally accepted accounting practice (GAAP). The Office of the Comptroller of the Currency, the Federal Reserve System, and the Federal Deposit Insurance Corporation require banks under their supervision to file quarterly reports ("call reports"). The accounting standards for call reports are set forth by the Federal Financial Institutions Examination Council, and generally conform to GAAP with respect to bad debts.

Under GAAP, a bank must show a bad debt reserve liability (or contra asset) for estimated losses on loans recorded as assets on the bank's books. The bank audit guide issued by the American Institute of Certified Public Accountants sets forth the following standard for the provision of adequate reserves: "The amount of the provision can be considered reasonable when the allowance for loan losses, including the current provision, is considered by management to be adequate to cover estimated losses inherent in the loan portfolio."[19] The reserve is maintained by charges against operating expenses. At the time that a loan is determined to be noncollectible, it is "charged off." The bank's assets are reduced by the amount of the loan principal that is unrecoverable, and bad debt reserves are reduced to the extent of the loss.

Some representatives of the banking industry have argued that the loan loss allowance provided under GAAP should be recognized for Federal income tax purposes. They argue that a bank's allowance for loan losses is subject to review by bank regulators, outside auditors, and other analysts and should be accepted by the Internal Revenue Service. The President's tax reform proposal would allow a bad debt deduction only when a loan is determined to be wholly or partially worthless. In many cases, this would occur when a loss is charged off under GAAP, but could occur later depending on facts and circumstances.

Economic accrual

To correctly measure income, a bad debt deduction should be accrued at the time that the economic loss occurs. For example, suppose that a bank makes 100 loans at the end of year 1, each amounting to one dollar and each maturing in 2 years (i.e., at the end of year 3). Assume that it anticipates that 10 percent of the loans will default each year and it charges sufficiently high interest rates on all 100 loans to make them profitable despite expected defaults. If the bank's loss expectation is accurate, the value of the loan portfolio will decline from $100 to $90 over year 2, from $90 to $81 over year 3, and from $81 to zero at the end of year 3 when $81 of principal is recovered. In this example, $10 of economic loss accrues in year 2 and $9 accrues in year 3. Correct income measurement would require that the $19 bad debt expense be deducted over a two year period as it economically accrues.[20] This would match the deduction of loan losses with the inclusion of interest income which compensates the lender for bearing risk.

---

[19] American Institute of Certified Public Accountants, *Audits of Banks*, 1983, p. 61.

If GAAP reserves were respected for Federal income tax purposes, as some commentators have recommended, then a $19 bad debt deduction likely would be allowed in year 1. Under GAAP, it can be argued that this is the amount that is necessary "... to cover estimated losses inherent in the loan portfolio." By contrast, the President's tax reform proposal would not allow a bad debt deduction before loan losses are charged off under GAAP. If loan losses are charged off promptly when they economically accrue, then the Administration proposal would result in a correct measurement of income from lending. However, a bank may not promptly charge off a portion of a loan when its market value drops.[21] In such circumstances, the bad debt deduction under the Administration proposal may be delayed beyond the time when the loss economically accrues.

If bad debts are not promptly charged off at the time loan losses economically accrue, then the specific charge-off method provided in the President's tax reform proposal may overstate economic income and resulting Federal income tax liability. However, modifying the Administration proposal to allow a deduction prior to the time that a bad debt is charged off would allow lenders to deduct bad debts before borrowers are required to include forgiveness of indebtedness income in their taxable incomes. Consistent income measurement would require that the bad debt deduction of the lender be coordinated with the forgiveness of indebtedness income of the borrower.[22]

Comparison of alternative accounting methods

Table 1 compares the measurement of income from a risky loan portfolio under (1) a mark-to-market system (i.e., economic accrual), (2) the experience method in current law, (3) GAAP, and (4) the Administration proposal, assuming that loan losses are charged off (for Federal income tax and books purposes) when they economically accrue. As in the example above, it is assumed that a bank makes 100 loans at the end of year 1, each in the amount of one dollar and each maturing in 2 years. The bank anticipates that 10 percent of the loans will default each year and, as a result, it charges a 20 percent interest rate on all 100 loans, instead of 10 percent that would be charged on a riskless loan. The bank's income tax rate is assumed to be 50 percent, and interest and tax rates are constant over the 3-year period.

---

[20] In general, if interest rates are constant over the period, the economic loss arising from default is equal to the fair market value (FMV) of the portfolio at the beginning of the period, plus new loans during the period, minus collections during the period, minus the FMV of the portfolio at the end of the period.

[21] The GAAP standard does not appear to compel a bank to charge off a loan until the chance of recovery is very small. Also, the charge off may be delayed until attempts to structure a work-out arrangement with the borrower completely fail. In addition, banks may be reluctant to promptly charge off defaults because of the adverse effect on reported income.

[22] Where the defaulting borrower is solvent, deferred recognition of forgiveness of indebtedness income results in a potential revenue loss to the Treasury.

In this example, the bank earns a 10 percent rate of return on its pre-tax cashflow after loan losses. Nevertheless, under alternative methods of accounting for bad debts, the bank's tax liability and its after-tax cashflow will vary. The impact of alternative accounting methods on the bank's tax liability can be summarized by the effective tax rate. The effective tax rate measures the difference between the pre-tax and after-tax rates of return as a percent of the pre-tax rate of return.

Table 1 shows that if the bank's bad debt deductions were determined under a mark-to-market system, the rate of return on its after-tax cashflow would be 5 percent. Consequently, its effective tax rate would be 50 percent (10 percent minus 5 percent, divided by 10 percent) which is the assumed statutory tax rate. The same effective tax rate would result under the Administration proposal. However, under the experience and GAAP methods of accounting, the bank's effective tax rate would be less than 50 percent. This occurs because bad debt deductions are accelerated relative to the mark-to-mark method of economic accrual. Under the experience method, losses are deducted one year earlier than under the mark-to-market system. Under the GAAP method, loan losses expected to be incurred in future years may be deducted at the time when repayment of the loan is recognized to be in jeopardy.

Table 1.—Cash Flows and Effective Tax Rates Under Various Methods of Accounting for Bad Debts

[Loans charged off promptly]

Item	Year 1	Year 2	Year 3	Total years 1 to 3	Internal rate of return	Effective tax rate [1]
Pre-tax Cashflow	−$100.00	$20.00	$99.00	$19.00	10.00%	NA
Loans made	100.00	0	0	100.00		
Collections	0	0	81.00	81.00		
Loss charged off	0	10.00	9.00	19.00		
Loan balance	100.00	90.00	0	NA		
Interest income	0	20.00	18.00	38.00		
After-tax Cashflow Computed Under Alternative Methods						
1. Mark-to-market	−100.00	15.00	94.50	9.50	5.00	50.0%
Interest income	0	20.00	18.00	38.00		
Bad debt deduction	0	10.00	9.00	19.00		
Taxable income	0	10.00	9.00	19.00		
Tax liability	0	5.00	4.50	9.50		
2. Experience method [2]	−95.00	19.50	90.00	9.50	5.26	47.4
Interest income	0	20.00	18.00	38.00		
Reserve balance	10.00	9.00	0	NA		
Bad debt deduction	10.00	9.00	0	19.00		
Taxable income	−10.00	11.00	18.00	19.00		
Tax liability	−5.00	5.50	9.00	9.50		

3. GAAP[3]	−90.50	10.00	90.00	9.50	5.40	46.0
Interest income	0	20.00	18.00	38.00		
Reserve balance	19.00	9.00	9.00	NA		
Bad debt deduction	19.00	0	0	19.00		
Taxable income	−19.00	20.00	18.00	19.00		
Tax liability	−9.50	10.00	9.00	9.50		
4. Administration proposal	−100.00	15.00	94.50	9.50	5.00	50.0
Interest income	0	20.00	18.00	38.00		
Bad debt deduction	0	10.00	9.00	19.00		
Taxable income	0	10.00	9.00	19.00		
Tax liability	0	5.00	4.50	9.50		

---

[1] The effective tax rate is computed as the difference between the pre-tax and after-tax internal rates of return divided by the pre-tax internal rate of return.

[2] Assumes that similar loans were made in previous years so that the ratio of charge offs in the current and 5 prior years to the loan balance in the current and 5 prior years is 10 percent.

[3] Assumes that losses inherent in portfolio are recognized in the year that loans are made.

In summary, the specific charge-off method of accounting for loan losses, as provided by the Administration proposal, correctly measures economic income if the lender promptly charges off bad debts when economic losses are incurred. In this case, lenders that use the experience method will claim bad debt deductions prior to the time when they economically accrue, and will reduce their effective rate of tax. This favors taxpayers that use the reserve method over taxpayers that use the specific charge-off method. The experience method favors banks with rapidly growing loan portfolios over banks with stable assets (since the tax benefit from accelerating bad debt deductions is larger when these deductions are growing over time).

Accrual vs. cash accounting

Some have criticized the Administration proposal on the ground that accrual method taxpayers in effect would be forced to use the cash method for losses—deducting bad debts only when charged off. It is argued that proper accrual accounting requires a current reserve deduction for losses that are anticipated to occur in order to match the accrual of interest income.[23] In response it can be argued that in a portfolio of loans of similar risk a higher interest rate is charged on all loans to compensate for the percentage of loans that actually default. Interest in excess of the risk-free rate (risk premium) compensates the lender for the possibility of loss. Thus, even though the interest on an individual loan that defaults is accrued prior to the time that the loan is charged off, in a portfolio context, the deduction for charging off a specific loan offsets risk premium income from the solvent portion of the portfolio (see Table 1).

The Administration proposal notes that if a deduction were allowed for additions to GAAP reserves, then an interest charge on reserve balances would be appropriate. This is the method provided in the Administration proposal in the case of property and casualty company loss reserves (i.e., the Qualified Reserve Account method). Under certain circumstances, it can be shown that this method is equivalent in present value to the specific charge-off method.[23a]

Incentive for building reserves

Apart from considerations of proper income measurement, some have argued that recognizing GAAP loan loss allowances for Federal income tax purposes is desirable because it would create a tax incentive for banks to increase their bad debt reserves. Under current law, banks may be reluctant to increase reserves because of the adverse effect on income and net worth as reported for financial and regulatory purposes. However, if these reserves were recognized for Federal income tax purposes, tax liability would decrease when reserves were strengthened.

---

[23] The Administration proposal would not change present law rules governing the accrual of interest income. In some cases, present law requires the accrual of interest due on a loan after the time bank regulators require that the loan be classified as "nonperforming." Some argue that the tax rules for the accrual of interest income should more closely conform to regulatory practices. However, regulatory accounting may be conservative in some cases so that income for regulatory purposes may be less than ecomomic income. The tax accrual of interest income and bad debt deductions are related—the nonaccrual of due but unpaid interest is equivalent to accruing such interest and, simultaneously, charging off a bad debt in the same amount.

[23a] *See*, Thomas Neubig and C. Eugene Stuerle, "The Taxation of Income Flowing Through Financial Institutions: General Framework and Summary of Tax Issues," Dept. of the Treasury, Office of Tax Analysis (September 1983).

As a matter of tax policy, it is not clear why it is desirable to increase reserves stated in financial and regulatory reports. The accounting standards used in preparing these reports may be conservative, reflecting bank regulators' concerns about ensuring solvency. To the extent that financial and regulatory accounting standards are conservative, book income may be smaller than economic income which, under the Administration proposal, is the proper measure of the tax base.

Administrative issues

Some have argued that an important disadvantage of the bad debt provision in the Administration proposal is that it could result in an increase in disputes between taxpayers and the Internal Revenue Service. Under the Administration proposal, a deduction for a bad debt would be allowed only when the debt is determined to be wholly or partially worthless and charged off the lender's books. It is argued that disputes may arise regarding when a debt is properly charged off. However, the same issue arises under current law. Taxpayers on the reserve method reduce beginning of year reserves by the amount of bad debts charged off. Under the Administration proposal, the determination of when a bad debt may be charged off for Federal income tax purposes would follow the standards in present law. Under the Administration proposal and current law, taxpayers have an incentive to charge off bad debts quickly for Federal income tax purposes (in order to reduce taxable income) and slowly for book purposes (to avoid a reduction in reported income). Thus, under the Administration proposal, the same standards would apply, and the same conflicts would arise, as under present law.

In response to administrative concerns about the President's proposal, it is noted that in 1983 over half of all banks were, in effect, on the specific charge-off method. This occured where a bank's reserve balance remained at its base year level. Many banks using the percentage of eligible loans method had frozen reserves as a result of the decline in the allowable percentage from 1.0 percent, in tax years beginning in 1982, to 0.6 percent in subsequent years. Where the reserve remained level, the bad debt deduction is just equal to the amount charged off for Federal income tax purposes. For banks in this situation, the specific charge-off method produces the same bad debt deduction as present law. For such banks, the administrative burden involved in switching to the specific charge-off method in the President's proposal would not be onerous.

Transition rule

To prevent banks from deducting losses under the new rules on loans for which a bad debt deduction was claimed under current law (thereby obtaining a double deduction), the Administration proposal requires that existing bad debt reserves be recaptured ratably over a 10-year period beginning with the first taxable year starting after 1985.

This transition rule is substantially more generous than simply requiring banks to use current law rules with respect to existing loans. The average ratio of tax reserves to net charge offs for Federal Deposit Insurance Corporation (FDIC) banks is estimated to be less than two in 1983. If this ratio is representative for banks as of the proposed effective date of the Administration proposal, then requiring current law treatment for outstanding loans would effectively recapture these reserves in less than two years. Thus, over a 5-year time horizon, the revenue gain from the 10-year recapture rule would be about one-half that of requiring banks to use current law rules with respect to existing loans.

The Administration proposal includes a provision to tax the windfall gain of taxpayers who claimed accelerated depreciation deductions at present law tax rates and, under the Administration proposal, would be taxed on income from this depreciated property at the proposed lower tax rates. However, the Administration proposal does not tax the windfall gain of taxpayers who claimed bad debt deductions at present law tax rates and would recapture these deductions at the proposed lower tax rates. It can be argued that since bad debt deductions reduced tax liability by 46 cents per dollar (at the 46-percent corporate rate), these deduction should be recaptured at 46 cents rather than 33 cents per dollar (at the proposed 33-percent corporate rate). The windfall gain from the proposed rate reduction could be taxed by increasing the amount of bad debt reserves included ratably in income under the Administration proposal by 39.4 percent (the difference between the current 46-percent tax rate and the proposed 33-percent tax rate, as a percent of the proposed tax rate).

2. Thrift Institutions

Present Law

Under present law, thrift institutions[24] are allowed to use either the specific charge-off method or the reserve method to account for their bad debt expenses for Federal income tax purposes. Where the reserve method is selected, the deduction is allowed for an annual addition to loan loss reserves under the "experience" method, the "percentage of eligible loans" method, or, if a sufficient percentage of the thrift's assets constitute "qualified assets," the "percentage of taxable income" method.

Experience method

The experience method for thrift institutions is identical to the bank experience method discussed above.

Percentage of eligible loans method

The computation for thrift institutions under this method is generally identical to the method for banks discussed above. However, the deduction for any year cannot exceed the amount by which 12 percent of the total deposits or withdrawable accounts of the depositors of the thrift at the close of the taxable year exceeds the sum of its surplus, undivided profits and reserves at the beginning of such year.

---

[24] The term "thrift institutions" is used herein to refer to mutual savings banks, domestic building and loan associations and those cooperative banks without capital stock which are organized and operated for mutual purposes and without profit.

Percentage of taxable income method

Under the percentage of taxable income method, an annual deduction is allowed for a statutory percentage of taxable income.[25] The statutory percentage for tax years beginning after 1978 is 40 percent. The percentage of taxable income deduction amount is added to the reserve in order to determine an ending balance in the reserve.

The full 40 percent of taxable income deduction is available only where 82 percent (72 percent in the case of mutual savings banks without capital stock) of the thrift institution's assets are qualified. Qualifying assets include general cash; obligations and securities of governmental entities including corporations which are instrumentalities of governmental entities; obligations of State corporations organized to insure the deposits of members; loans secured by a deposit or share of a member; loans secured by residential or church real property and residential and church improvement loans; loans secured by property, or for the improvement of property, within an urban renewal area; loans secured by an interest in educational, health or welfare institutions or facilities; property acquired through defaulted loans on residential, church, urban development or charitable property; educational loans; and property used in the business of the association. Where the 82-percent test is not met, the statutory rate is reduced by three-fourths of one percentage point for each one percentage point of such shortfall.[26] For mutual savings banks without capital stock, the statutory rate is reduced by 1-1/2 percentage points for each percentage point that qualified assets fail to reach the 72-percent requirement. At a minimum, 60 percent of a thrift institution's assets must be qualifying (50 percent for mutual savings banks without stock) in order to be eligible for deductions under the percentage of taxable income method at all.

As in the case for the percentage of eligible loans method, the deduction for any year under the percentage of taxable income method cannot exceed the amount by which 12 percent of the total deposits or withdrawable accounts of the depositors of the thrift at the close of the taxable year exceeds the sum of its surplus, undivided profits and reserves at the beginning of such year.

A thrift may switch between methods of determining the addition to its bad debt reserve from one year to another. Such a change does not, however, result in a change in the balance in the bad debt reserve account at the beginning of the year in which the change occurs.

---

[25] Code sec. 593. For purposes of determining the deduction under the percentage of taxable income method, taxable income is computed without regard to any deduction allowable for any addition to the reserve for bad debts and exclusive of 18/46 of any net long-term capital gain, gains on assets the interest on which was tax-exempt, any dividends eligible for the corporate dividends received deduction and any additions to gross income from the thrift's own distributions from previously accumulatd reserves.

[26] For example, consider a thrift institution (other than a mutual savings bank) which has only 75 percent of its assets in qualified assets. The shortfall is 7 percentage points, so the statutory rate is reduced by 5-1/4 percentage points to 34-3/4 percent of taxable income.

Under present law, if the bad debt reserve deduction for the taxable year determined under the above rules exceeds the amount which would have been allowed as a deduction on the basis of actual experience, the deduction is reduced by 20 percent of such excess (sec. 291). Also, 59-5/6 percent of the deductible excess (after the 20-percent reduction) is treated as a tax preference for purposes of computing the corporate minimum tax (sec. 57).

The availability of the percentage of taxable income method is not scheduled for expiration under present law. Thrift institutions will not have the alternative of the percentage of eligible loans method for taxable years beginning after 1987.

A special recapture provision applies to reserve balances in excess of the balance computed under the experience method. When a thrift institution distributes property to its owners, other than as interest or dividends on deposits, in excess of earnings and profits accumulated in taxable years beginning after December 31, 1951, the excess is treated as distributed from the bad reserve account to the extent of the excess of total reserves over experience method reserves. When such a distribution takes place, the thrift institution is required to reduce its reserve by such an amount and simultaneously recognize the amount as an item of gross income. This process increases current year's earnings and profits, and causes such distributions to be taxable to the recipient as dividends in the amount of any excess distributed, rather than as a nontaxable return of capital or as capital gains.

Determination of worthlessness

The determination of worthlessness of a debt under present law is the same as for banks discussed above.

Background

Legislative history

Savings and loan associations, cooperative banks, and mutual savings banks were specifically exempted from Federal income tax prior to 1952 under section 101(2) of the 1939 Code. The Revenue Act of 1951 defined "bank" to include thrift institutions, thereby depriving these organizations of their tax-exempt status. At the same time thrift institutions were deprived of their tax-exempt status, they were allowed to establish a reserve for bad debts up to 100 percent of taxable income to fund this reserve. Consequently, although subject to Federal income tax, thrift institutions paid very little actual tax as a result of the 1951 change.

In the Revenue Act of 1962, Congress established a statutory bad debt deduction for thrift institutions that generally were lower than those permitted under the 1951 Act. A thrift could elect either an annual addition to reserves of 60 percent of its taxable income (subject to a maximum loss reserve of 6 percent of qualifying real property loans) or establish a loss reserve of 3 percent of qualifying real property loans plus a percentge of other loans based on actual experience. Savings and loan associations and cooperative banks could take advantage of these provisions only if 82 percent of their assets were invested in residential real estate, liquid assets, and certain other qualifying assets (qualified assets test). However, mutual savings banks were not subject to the 82 percent of assets test. The actual experience method was approved as an election for all thrift institutions and a special 5 percent of loans rate was provided for the first $4 million of qualifying loans of new mutual thrift institutions for their first five years of existence.

The Revenue Act of 1962 also established the rule requiring recapture of bad debt reserves in excess of the experience method when distributions to shareholders exceeded current and accumulated earnings and profits. The House Committee on Ways and Means originally reported a more comprehensive recapture provision which would have required recapture of bad debt reserves balances in excess of the balance required under the experience method on distribution to shareholders, whether or not earnings and profits were present. This rule was based on a belief that the special bad debt reserve provisions for thrift institutions were for the protection of depositors and that distributions should not be made to shareholders until full income tax had been paid with respect to the profits so distributed.[27] As passed, however, distributions were treated as coming from the untaxed reserves, and hence subject to recapture, only after earnings and profits had been exhausted (present law).

The Tax Reform Act of 1969 established the basics of the present system. The alternative 3-percent method was eliminated in favor of the experience and percentage of loan methods applicable to banks, and the 60 percent of taxable income deduction was phased down to a 40-percent deduction over 10 years. The qualified assets test was extended to mutual savings banks (at a 72-percent rate). A special provision was added which provided that, where the qualified assets test was not met but at least 60 percent of assets were qualified (50 percent for mutual savings banks), the bad debt deduction would still be available under the percentage of taxable income method, but in a reduced amount.

The Tax Reform Act of 1969 also provided that the excess of the bad debt deduction of a financial institution (including a thrift institution) over the bad debt deduction which would have been allowed under the experience method constitutes an item of tax preference for purposes of the corporate minimum tax.

The Economic Recovery Tax Act of 1981 expanded the definition of organizations eligible for the bad debt rules for thrift institutions to include stock savings banks. The rules applicable to stock savings banks are the same as those applicable to savings and loan associations. The Tax Equity and Fiscal Responsibility Act of 1982 reduced the bad debt deducton of thrift institutions using a method other than the specific charge-off method or the bank experience method by 15 percent of the excess of the deduction otherwise allowable over the deduction which would have been allowable under the experience method. This reduction was part of a boarder cutback in tax preferences. Concurrently, the portion of the actual deduction in excess of the amount allowable under the experience method constituting a tax preference item for purposes of the minimum tax was reduced to 71.6 percent. The Deficit Reduction Act of

---

[27] H. Rep. No. 1447, 87th Congress, 2d Sess. (1962).

1984 increased the cutback of deduction to 20 percent of the excess of the deduction over that allowable under the experience method and decreased the minimum tax preference inclusion rate to 59-5/6 percent.

Financial accounting methodology

The financial accounting methodology for thrift institutions is the same as for banks.

Regulatory accounting

For regulatory purposes, thrift institutions are no longer required to maintain specific reserves to offset potential bad debt losses. Instead, the Federal Home Loan Bank Board (FHLB) requires that thrift institutions insured by the Federal Savings and Loan Insurance Corporation (FSLIC) satisfy a minimum net worth requirement designed to guarantee adequate capitalization of the institution.[28] The present net worth requirement consists of the sum of the amounts determined under four separate factors. These are the "base factor" (generally 3 percent of most liabilities), the "growth factor" (a varying percentage determined by the rate of growth in liabilities), the "contingency factor" (including 2 percent of recourse liabilities, 10 percent of the amount of direct investment in non-traditional activities, and 20 percent of "scheduled items")[29] and the amortization factor (a phase-in of the more restrictive application of the net worth rules). For regulatory purposes, net worth consists of all reserve accounts (other than those related to the valuation of a specific asset), retained earnings and all capital stock accounts.[30]

The primary focus of regulatory concern is to insure that adequate capitalization exists within an institution to support the level of activities in which the institution is engaged. The presence of adequate capitalization minimizes the risk of failure which would result in the FSLIC being required to fulfill its obligation to the institution's depositors. This focus is substantially different from the focus of tax accounting (the measurement of net income in a given period) or the principle focus of financial accounting (the measurement of the net value of the assets given potential impairment). For this reason, the amount of the requirement is measured primarily with respect to the amount of the institution's liabilities. Where asset values are considered (such as through the contingency factor), it is to measure a potential dimunition in the asset's value as that dimunition could affect the ability of the institution to meet its obligations. Total capitalization, including reserve accounts, is measured since it is ability to meet obligations that is the concern. Had no reserve accounts been maintained, the equity of the institution would be increased by the amount which would exist in the reserves. So long as the minimum amount of net equity is kept, distribution of amounts, which would otherwise not have been available due to their being placed in a reserve, is prevented.

---

[28] 12 C.F.R. sec. 563.13 (1985). The present regulations became effective on March 21, 1985. Prior to that time, a joint requirement of a reserve for liabilities to depositors in insured accounts and a minimum net worth requirement applied. The change unified the two requirements into a single net worth requirement and expanded the elements which are considered in determining required minimum net worth.

[29] Scheduled items include "slow loans" and foreclosed real estate among other items. 12 C.F.R. sec. 561.15.

[30] 12 C.F.R. sec. 561.13.

Administration Proposal

The Administration proposal would repeal the use of the experience, percentage of eligible loans and percentage of taxable income methods for thrift institutions effective for tax years beginning on or after January 1, 1986. Under the Administration proposal, deductions for bad debts would be allowed when the loans are partially or wholly worthless (i.e., the specific charge-off method would be used). This results in the same treatment for thrift institutions as for all other taxpayers. That portion of the reserve balance on the effective date which is equal to the greater of the reserve which would be required under the experience or percentage of eligible loans methods will be required to be taken into income ratably over ten years. At the election of the thrift, the portion of the reserve to be included in income can be taken entirely in the first tax year the proposal is effective.

Other Proposals

1984 Treasury Report

Like the Administration proposal, the 1984 Treasury report would repeal the use of the three reserve methods. However, the Treasury proposal would require the inclusion in income over a 10-year period of the entire reserve amount, not just the greater of the reserve amounts computed under the experience or the percentage of eligible loans methods. The alternative to elect immediate inclusion of the reserve amount rather than inclusion over a 10-year period would not be available.

S. 409 and H.R. 800 (Bradley-Gephardt)

The Bradley-Gephardt bill would repeal the percentage of eligible loans method and the percentage of taxable income method effective for tax years beginning after December 31, 1986. The experience method would be retained.

H.R. 2222 and S. 1006 (Kemp-Kasten)

The Kemp-Kasten bill would repeal the percentage of eligible loans method and the percentage of taxable income method effective for tax years beginning after December 31, 1986. The experience method would be retained. (The Kemp-Kasten and Bradley-Gephardt bills are identical with respect to the bad debt reserves of thrift institutions and banks.)

S. 1263 (Roth) and H.R. 2874 (Flippo-Frenzel)

The bill would require that tax bad debt reserves for commercial banks be conformed to the bad debt reserve maintained for financial statement purposes, up to a maximum reserve of 1.5 percent of total loans. The greatest tax deduction in any one year would be limited to 0.5 percent of total loans of the taxpayer at the end of that year. Any initial increase in the tax reserve due to the conformity requirement would be spread over 6 years. The changes would apply with respect to taxable years beginning after 1984. The bill would repeal the current experience method and percentage of eligible loans method of computing reserves for bad debts of commercial banks.

Analysis

Overview

Taxpayers generally are not allowed to deduct future liabilities or expenses until the event giving rise to the liability or expense occurs. In the case of loans, the Federal income tax laws have since 1921 have allowed taxpayers to deduct additions to bad debt reserves; that is, to accumulate a bad debt reserve out of pre-tax rather than after-tax, income. Absent the special provisions for bad debt reserves, taxpayers would not be allowed to deduct a loan loss until the loan is determined to be wholly or partially worthless.

Thrift institutions (i.e., mutual savings banks, domestic building and loan associations, savings and loan associations, and cooperative banks without capital stock) are granted more favorable Federal income tax treatment in the computation of their bad debt deductions than banks and other creditors. Thrift institutions are allowed to compute the deductible addition to their bad debt reserves under the percentage of taxable income method in addition to any of the three methods available to commercial banks (i.e., the experience method, the percentage of eligible loans method, and the specific charge-off method).

The bad debt deduction of thrift institutions can be viewed as comprised of two components: (1) the deduction that would be allowable if thrift institutions were subject to the same rules as commercial banks, and (2) the deduction in excess of this amount. The main issue there is whether the reserve method of accounting for bad debts more accurately measures the economic income of lenders than the specific charge-off method that would be required by the Administration proposal. To the extent that the percentage of taxable income method for thrift institutions results in a larger bad debt deduction than the methods available to commercial banks, this can be viewed as a tax incentive for encouraging thrift institutions to specialize in residential mortgage lending and certain other qualified lending. With respect to the component of thrift bad debt deductions intended as an incentive for qualified lending, the main issue is whether or not there should be such an incentive and, if so, whether the incentive is effective. A second issue is the Federal income tax treatment under the Administration's proposal of bad debt reserves accumulated on existing loans.

Incentive component of thrift bad debt reserves

The percentage of taxable income method for thrift institutions was designed at least in part to encourage residential mortgage lending. However, the present system is estimated to cost $1 billion per year in lost Federal tax revenue,[31] and may not be well designed to achieve its objective. Under present law, commercial banks and investors other than thrift institutions (which are excluded from the percentage of taxable income method) are given no tax incentive to engage in residential mortgage lending. Thrift institutions with less than 60 percent of assets invested in residential mortgages and other qualifying assets also have no incentive to increase their mortgage lending, nor do thrift institutions whose qualifying assets exceed 82 percent of total assets (72 percent for mutual savings banks). The 10-point difference in the asset requirements between savings and loan association and mutual savings banks appears to create an uneven playing field for competition between these institutions. Also, to the extent that the present system encourages thrift institutions to specialize in mortgage lending (at least up to the 82- and 72-percent levels), it is inconsistent with regulatory policies that encourage greater diversification of loan portfolios.

---

[31] Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 1986-1990* (JCS-8-85), April 12, 1985.

The Administration proposal would require banks and thrift institutions to compute their tax in the same manner as other corporations, that is, to use the specific charge-off method for deducting loan losses. The efect of such a change will be to increase the marginal rate of tax for these institutions from 31.4 percent to 33 percent. The present law tax advantage of thrift institutions relative to commercial banks and other corporations would be eliminated, as would the tax incentive for thrift institutions to specialize in residential mortgage lending. If Congress desires to retain a tax incentive for residential mortgage lending, then a generalized tax incentive available to all mortgage lenders could be enacted. However, it should be noted that one of the present law tax preferences retained by the Administration proposal is the deductibility of interest on loans secured by a taxpayer's principle residence. This tax expenditure, estimated to reduce Federal income tax revenues by over $27 billion in fiscal year 1986, provides a substantial incentive for homeownership and residential mortgage lending. The Administration proposal also retains the provisions of present law that defer and exclude a portion of capital gains realized from the sale of a principal residence.

Transition rule

The Administration proposal would allow lenders to deduct loans charged off in taxable years beginning after 1985, even though reserve deductions may have been claimed for these loans in prior tax years. To prevent a double deduction of loan losses, taxpayers other than thrift institutions would be required to include existing bad debt reserves in income over a 10-year period beginning with the first taxable year starting after 1985. In the case of thrift institutions using the percentage of taxable income method, the incentive portion of bad debt reserves would not be recaptured (i.e., included in taxable income). The incentive portion of thrift bad debt reserves would be determined as the excess of existing reserves over the greater of reserves computed using the two alternative reserve methods available to thrift institutions under present law (i.e., the experience and percentage of eligible loan methods). Thus, the transition rule for thrift institutions is more generous than that for other lenders since a portion of existing reserves may be exempted from current tax.

The non-incentive portion of thrift reserves would be recaptured over 10 years in the same manner as the bad debt reserves of taxpayers other than thrift institutions. Since the amount subject to recapture is limited to the greater of reserves computed under the experience and percentage of eligible loan methods, thrift institutions would have an incentive to rearrange their portfolios in such a manner as to reduce the amount recaptured and, correspondingly, increase the amount forgiven. Where the percentage of eligible loans method results in larger reserves than the experience methods, thrift institutions could reduce the recapture amount by exchanging qualified assets (such as home mortgages) for nonqualified assets (such as Government National Mortgage Association certificates) immediately before the effective date. To prevent this type of manipulation, the Administration proposal could be modified to recapture reserves computed according to the percentage of eligible loans method as of December 31, 1984 (or some other date prior to release of the Administration proposal), if greater than the amount otherwise subject to recapture.

The Administration proposal does not tax the windfall gain of taxpayers who claimed bad debt deductions at present law tax rates and would recapture these deductions at the proposed lower tax rates. It can be argued that since bad debt deductions reduced tax liability by 46 cents per dollar (at the 46-percent corporate rate), these deductions should be recaptured at 46 cents rather than 33 cents per dollar (at the proposed 33-percent corporate rate). The windfall gain from the proposed rate reduction could be taxed by increasing the amount of bad debt reserves included ratably in income under the Administration proposal by 39.4 percent (the difference between the current 46-percent tax rate and the proposed 33-percent tax rate, as a percent of the 33-percent tax rate).

Under present law, distributions to shareholders by domestic building and loan associations and institutions that are treated as mutual savings banks, are subject to a tax benefit rule. Distributions in excess of earnings and profits (accumulated after 1951) are treated as made out of bad debt reserves for qualifying loans in excess of reserves determined using the experience method. In addition, such distributions are included in the gross income of the payor. The effect of this provision is to recapture the tax benefits associated with the percentage of taxable income method of computing bad debt reserves to the extent that an investor-owned thrift institution distributes retained earnings attributable to these tax benefits. Under the Administration proposal, it is unclear whether distributions out of bad debt reserves that are not recaptured would be subject to the tax benefit rule in present law. Since the tax benefit rule was part of present law when investor-owned thrift institutions took advantage of the percentage of taxable income method, it can be argued that an exemption from this rule would constitute retroactive tax relief to investors in these institutions.

Some thrift institutions have followed financial accounting procedures which treat the tax deduction for bad debts under the percentage of income method as a reduction in their effective tax rate rather than as a timing difference. As a result, no amounts currently exist in their deferred tax reserve accounts to cover the additional tax resulting from the Administration's proposal to recapture a portion of the bad debt reserve. It is likely that all additional tax due to recapture would be required to be reported for financial purposes as an expense in the year the provision becomes effective, irrespective of the fact that it would be paid over a ten-year period. A similar approach would likely be required for regulatory purposes.

A certain level of net worth is required for regulatory purposes. Thus, it is argued that a sudden decrease in net worth as a result of the Administration proposal could result in many thrifts failing to meet regulatory requirements. In response, it is argued that the problem lies not with the Administration's recapture proposal, but rather with the failure of certain thrift institutions to show a deferred tax liability on their balance sheets. Thus, it is argued, the problem is one of a failure to follow adequate accounting procedures in the past, and not a problem of tax policy.

B. Interest on Debt Used to Purchase or Carry Tax-Exempt Obligations

Present Law and Background

In general

Present law (sec. 265(2)) disallows a deduction for interest on indebtedness incurred or continued to purchase or carry tax-exempt obligations. This rule applies both to individual and corporate taxpayers. The rule also applies to certain cases in which a taxpayer incurs or continues interest expense and a related person acquires or holds tax-exempt obligations (sec. 7701(f)).[32]

Application to taxpayers generally

The Internal Revenue Service and the courts have consistently interpreted section 265(2) to disallow an interest deduction only when a taxpayer incurred or continued indebtedness for the purpose of acquiring or holding tax-exempt obligations.[33] They have employed various tests to determine whether a taxpayer has the prohibited purpose. In general, when a taxpayer has independent business or personal reasons for incurring or continuing debt, the taxpayer has been allowed an interest deduction regardless of his tax-exempt holdings. When no such independent purpose exists, and when there is a sufficiently direct connection between the indebtedness and the acquisition or holding of tax-exempt obligations, a deduction has been disallowed.

In *Wisconsin Cheeseman, Inc. v. United States*, 388 F. 2d 420 (7th Cir. 1968), an interest deduction was disallowed for a corporation which took out short-term bank loans to meet recurrent seasonal needs for funds, pledging tax-exempt securities as collateral. The court held that the taxpayer could not automatically be denied a deduction because it had incurred indebtedness while holding tax-exempt obligations. However, use of the securities as collateral established a sufficiently direct relationship between the loans and the purpose of carrying tax-exempt securities. The court stated further that a deduction should not be allowed if a taxpayer could reasonably have foreseen, at the time of purchasing tax-exempts, that a loan would probably be required to meet ordinary, recurrent economic needs.

---

[32] In addition to interest deductions, present law (sec. 265(1)) denies a deduction for nonbusiness expenses for the production of tax-exempt interest income, which expenses would otherwise be deductible under section 212. This may include, for example, brokerage and other fees associated with a tax-exempt portfolio. Present law also disallows deductions for certain expenses of mutual funds which pay tax-exempt dividends and for interest used to purchase or carry shares in such a fund.

[33] Legislative history indicates that Congress intended the purposes test to apply. *See*, e.g., S. Rep. No. 617, 65th Cong., 3d Sess. 6-7 (1918); S. Rep. No. 398, 68th Cong., 1st Sess. 24 (1924); S. Rep. No. 558, 73d Cong., 2d Sess. 24 (1934).

In Rev. Proc. 72-18, 1972-1 C.B. 740, the Internal Revenue Service provided guidelines for application of the disallowance provision to individuals, dealers in tax-exempt obligations, other business enterprises, and banks in certain situations.[34]

Under Rev. Proc. 72-18, a deduction is disallowed only where indebtedness is incurred or continued for the purpose of purchasing or carrying tax-exempt obligations. This purpose may be established either by direct or circumstantial evidence. Direct evidence of a purpose to purchase tax-exempt obligations exists where the proceeds of indebtedness are directly traceable to the purchase of tax-exempt obligations or when such obligations are used as collateral for indebtedness, as in *Wisconsin Cheeseman* above. In the absence of direct evidence, a deduction is disallowed only if the totality of facts and circumstances establishes a sufficiently direct relationship between the borrowing and the investment in tax-exempt obligations. A deduction generally is not disallowed for interest on an indebtedness of a personal nature (e.g., residential mortgages) or indebtedness incurred or continued in connection with the conduct of an active trade or business.

Under Rev. Proc. 72-18, when there is direct evidence of a purpose to purchase or carry tax-exempt obligations, no part of the interest paid or incurred on the indebtedness (or on that portion of the indebtedness directly traceable to the holding of particular tax-exempt obligations) may be deducted. In other cases, an allocable portion of interest is disallowed, to be determined by multiplying the total interest on the indebtedness by the ratio of the average amount during the taxable year of the taxpayer's tax-exempt obligations to the average amount of the taxpayer's total assets.

Rev. Proc. 72-18 provides specifically that dealers in tax-exempt obligations are denied an interest deduction when they incur or continue indebtedness for the purpose of holding tax-exempt obligations, even when such obligations are held for resale.[35] When dealers incur or continue indebtedness for the general purpose of carrying on a brokerage business, which includes the purchase of both taxable and tax-exempt obligations, an allocable portion of interest is disallowed. However, the disallowance rule generally does not apply where indebtedness is incurred to acquire or improve physical facilities. The revenue procedure does not specify under what circumstances, if any, a bank is to be treated as a dealer in tax-exempt obligations.

Application to financial institutions

Allowance of deduction for interest paid on deposits

Legislative history suggests that Congress did not intend the disallowance provision to apply to the indebtedness incurred by a bank or similar financial institution to its depositors.[36] The IRS took the position as early as 1924 that indebtedness to depositors was not incurred to purchase or carry tax-exempt obligations, within the meaning of the law. In Rev. Rul. 61-22, 1961-2 C.B. 58, the IRS restated its position that the provisions of the law "have no application to interest paid on indebtedness represented by deposits in banks engaged in the general banking business since such indebtedness is not considered to be "indebtedness incurred or continued to purchase or carry obligations * * *" within the meaning of section 265."

---

[34] That is, those situations not covered by Rev. Proc. 70-20, 1970-2 C.B. 499, discussed below.

[35] *See*, *Leslie v. Comm'r*, 413 F.2d 636 (2d Cir. 1969), *cert. den.* 396 U.S. 1007 (1970). The court in *Leslie* held specifically that the exemption of banks under the disallowance provision did not apply to a brokerage business.

[36] *See* S. Rep. No. 558, 73d Cong., 2d Sess. 24 (1934); S. Rep. No. 830, 88th Cong., 2d Sess. 80 (1964).

Despite this general rule, the IRS has attempted to disallow interest deductions of financial institutions in certain cases. Rev. Rul. 67-260, 1967-2 C.B. 132, provided that a deduction will be disallowed when a bank issues certificates of deposit for the specific purposes of acquiring tax-exempt obligations. The ruling concerned a bank which issued certificates of deposit in consideration of, and in exchange for, a State's tax-exempt obligations, the certificates having approximately the same face amount and maturity dates as the State obligations.

In Rev. Proc. 70-20, 1970-2 C.B. 499, the IRS issued guidelines for application of the disallowance provision to banks holding tax-exempt State and local obligations. Rev. Proc. 70-20 provides that a deduction will not be disallowed for interest paid or accrued by banks on indebtedness which they incur in the ordinary course of their day-to-day business, unless there are circumstances demonstrating a direct connection between the borrowing and the tax-exempt investment. The IRS will ordinarily infer that a direct connection does not exist (i.e., a deduction will ordinarily be allowed) in cases involving various forms of short-term indebtedness,[37] including deposits and certificates of deposit; short-term Eurodollar deposits and borrowings; Federal funds transactions and similar interbank borrowing; repurchase agreements; and borrowing directly from the Federal Reserve to meet reserve requirements. Within these categories, unusual facts and circumstances outside of the normal course of business may demonstrate a direct connection between the borrowing and the investment in tax-exempt securities; in these cases, a deduction will be disallowed. However, IRS will not infer a direct connection merely because tax-exempt obligations were held by the bank at the time of its incurring indebtedness in the course of its day-to-day business.

Under Rev. Proc. 70-20, application of the disallowance provision to long-term capital notes is to be resolved in the light of all the facts and circumstances surrounding the issuance of the notes. A deduction is not to be disallowed for interest on indebtedness created by the issuance of capital notes for the purpose of increasing capital to a level consistent with generally accepted banking practice. Types of borrowings not specifically dealt with by the revenue procedure are to be decided on a facts and circumstances basis. Additionally, Rev. Proc. 72-18, discussed above, is applicable to financial institutions in situations not dealt with in Rev. Proc. 70-20.[38]

---

[37] For purposes of the revenue procedure, "short-term bank indebtedness" means indebtedness for a term not to exceed three years. A deposit for a term exceeding three years is treated as short-term when there is no restriction on withdrawal, other than loss of interest.

Since the issuance of Rev. Proc. 70-20, several cases and rulings have addressed the issue of bank deposits or similar arrangements which are secured or collateralized by tax-exempt obligations. These decisions have generally refrained from applying the disallowance provision.

Rev. Proc. 78-34, 1978-2 C.B. 535, allowed a deduction for interest paid by commercial banks on borrowings of Treasury tax and loan funds when those borrowings are secured by pledges of tax-exempt obligations. The IRS took the position that this type of borrowing is in the nature of a demand deposit.

In *Investors Diversified Services, Inc. v. United States,* 573 F. 2d 843 (Ct. Cl. 1978), the court found that the use of tax-exempt securities as collateral for face-amount certificates[39] was not sufficient evidence of a purpose to purchase or carry tax-exempt obligations and, therefore, allowed an interest deduction. Noting various similarities between banks and face-amount certificate companies, the court held that the rationale for the "bank exception" to the disallowance provision was equally applicable to these companies. The court cited three further grounds for holding the disallowance provision inapplicable: (1) that the sale of certificates (i.e., borrowing) was wholly separate from and independent of the company's investment process, including the acquisition and maintenance of tax-exempt securities; (2) that the essential nature of the company's business was the borrowing of money which had to be invested in order to pay off the certificate holders; and (3) that the company could not reduce its borrowings by disposing of its tax-exempt securities, since only the certificate holders had the power to terminate each certificate.

Finally, in *New Mexico Bancorporation v. Comm'r.,* 74 T.C. 1342 (1980), the Tax Court permitted a bank a deduction for interest paid on repurchase agreements which were secured by tax-exempt State and municipal obligations. The court concluded that the repurchase agreements were similar to other types of bank deposits, and were not the type of loans or indebtedness intended to be covered by the disallowance provision. Furthermore, the bank's purpose for offering repurchase agreements was independent of the holding of tax-exempt obligations.[40]

---

[38] Rev. Proc. 70-20 was modified by Rev. Proc. 83-91, 1983-2 C.B. 618, to provide that a deduction will generally not be disallowed in the case of repurchase agreements collateralized by tax-exempt securities (as well as those collaterialized by taxable obligations). This modification was in response to the decision in *New Mexico Bancorporation v. Comm'r,* 74 T.C. 1342 (1980) (discussed below).

[39] Face-amount certificates are certificates under which the issuer agrees to pay to the holder, on a stated maturity date, at least the face amount of the certificate, including some increment over the holder's payments. Present law (sec. 265(2)) provides that interest paid on face-amount certificates by a registered face-amount certificate company shall not be considered as interest incurred or continued to purchase or carry tax-exempt obligations, to the extent that the average amount of tax-exempt obligations held by such institution during the taxable year does not exceed 15 percent of its average total assets. The *Investor Diversified Services* case involved a face-amount certificate company whose tax-exempt holdings exceeded 15 percent of its total assets.

[40] Rev. Proc. 80-55, 1980-2 C.B. 849, would have disallowed a deduction for interest paid by commercial banks on certain time deposits made by a State and secured by pledges of tax-exempt obligations. The revenue procedure concerned banks that participate in a State program that requires the banks to bid for State funds and negotiate the rate of interest, and requires

Continued

20-percent reduction in preference items

Under a provision originally added by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), and modified by the Deficit Reduction Act of 1984, the amount allowable as a deduction with respect to certain financial institution preference items is reduced by 20 percent. (The original TEFRA rule provided for a 15 percent reduction.) Financial institution preference items include interest on indebtedness incurred or continued by financial institutions[41] to purchase or carry tax-exempt obligations acquired after December 31, 1982, to the extent that a deduction would otherwise be allowable for such interest. Unless the taxpayer (under regulations to be prescribed by the Treasury) establishes otherwise, the 20 percent reduction applies to an allocable portion of the taxpayer's aggregate interest deduction, to be determined by multiplying the otherwise allowable deduction by the ratio of the taxpayer's average adjusted basis of tax-exempt obligations during the year in question to the average adjusted basis of the taxpayer's total assets. For example, a bank which invests 25 percent of its assets in tax-exempt obligations is denied a deduction for $5,000 of each $100,000 of interest paid to its depositors during the taxable year (20 percent X $25,000 interest allocable to debt used to acquire or hold tax-exempts). For purposes of this provision, interest specifically includes amounts paid in respect of deposits, investment certificates, or withdrawable or repurchasable shares, whether or not formally designated as interest.

Administration Proposal

The Administration proposal would deny banks, thrift institutions, and other financial institutions a deduction for any interest payments that are allocable to the purchase or carrying of tax-exempt obligations acquired on or after January 1, 1986. The amount of interest allocable to tax-exempt obligations would be determined as it is for purposes of the 20 percent reduction in preference items under present law. Thus, a deduction would be denied for that portion of a bank's otherwise allowable interest deduction that is equivalent to the ratio of (1) the average adjusted basis during the year of tax-exempt obligations held by the bank and acquired on or after January 1, 1986, to (2) the average adjusted basis of all assets held by the bank. For example, if an average of one-third of a bank's assets during the year consisted of tax-exempt obligations acquired in 1986 or later years, the bank would be denied one-third of its otherwise allowable interest deduction. The proposal states that this pro rata presumption would be irrebutable.[42]

---

the State to leave such deposits for a specified period of time. The IRS took the position that direct evidence of a purpose to purchase or carry tax-exempt obligations exists in such transactions under Rev. Proc. 72-18. Rev. Proc. 80-55 was revoked by Rev. Proc. 81-16, 1981-1 C.B. 688. However, Rev. Proc. 81-16 states that the disallowance provision will continue to apply to interest paid on deposits that are incurred outside of the ordinary course of the banking business, or in circumstances demonstrating a direct connection between the borrowing and the tax-exempt obligations.

[41] The provision applies to commercial banks, mutual savings banks, domestic building and loan associations, and cooperative banks.

[42] Administration proposal, p. 244.

Under the Administration proposal, the 20 percent disallowance rule would continue to apply with respect to tax-exempt obligations acquired between January 1, 1983, and December 31, 1985. Thus, a financial institution would reduce its otherwise allowable interest deduction by the sum of (1) 100 percent of interest allocable to tax-exempt obligations acquired in 1986 or later years, and (2) 20 percent of interest allocable to tax-exempt obligations acquired in calendar years 1983 through 1985, each determined under the formula above. For example, if 25 percent of a bank's assets consisted of tax-exempt obligations acquired in 1986 or later years, and an additional 25 percent consisted of tax-exempt obligations acquired in 1983, 1984, or 1985, the bank would be denied 30 percent of its otherwise allowable interest deduction (i.e., 25 percent attributable to obligations acquired in or after 1986, and 5 percent (.20 x 25 percent) attributable to obligations acquired in 1983-85).

Analysis

The allowance of interest deductions to financial institutions which acquire or hold tax-exempt obligations raises a number of legal and policy issues. These include (1) administrative problems, including the tracing of borrowed funds and, in the absence of tracing, the allocation of funds among different purposes of the taxpayer; (2) a concern for tax equity, since financial institutions are generally allowed to deduct interest on debt used to finance the acquisition or holding of tax-exempt obligations, while most other taxpayers are prohibited from doing so; and (3) the probable effect of any modification of the existing rule on the market for tax-exempt State and municipal bonds.

Administrative problems

The disallowance provision generally

The basic policy of the disallowance provision is to prevent a taxpayer from receiving tax-exempt income and paying tax-deductible interest on the same or equivalent funds. Thus, in a simple case, a taxpayer who borrows $10,000, which he then immediately invests in tax-exempt obligations, is denied a deduction for interest paid to the lender on the $10,000. This prevents a result under which the taxpayer, by receiving the benefits of both tax-exempt income and the interest deduction, could offset taxes on other income (and thereby reduce Federal tax revenues) merely by serving as a passthrough for the funds.

As the taxpayer's finances become more complex, the administration of the disallowance provision becomes progressively more complicated. Because money is fungible—that is, one $10,000 is the same as any other $10,000—it is difficult to determine whether a taxpayer is financing the acquisition or holding of particular tax-exempt obligations with the proceeds of any particular indebtedness. It may be even more difficult to determine whether the taxpayer has the actual purpose of doing so. This is particularly true in the case of a corporation (or a wealthy individual) which constantly incurs debt for a variety of purposes and which also, in separate transactions, acquires and holds tax-exempt obligations.

Application to banks

The fungibility problem is particularly acute with respect to banks,[43] whose major business consists of the lending and borrowing of interchangeable sums of money, including (to varying degrees) the acquisition and holding of tax-exempt obligations. Even the purposes test, when applied to banks, may result in conflicting conclusions. A bank may argue that, in accepting deposits, it is simply carrying on its general business as a bank—in a sense, that it has an independent business purpose for incurring debt to its depositors. According to this view, the bank should be allowed an interest deduction under the general principles applicable to all taxpayers. Alternatively, the bank may argue that the acceptance of deposits does not constitute borrowing, at all.[44] It may also be argued, however, that an equally established purpose of a bank's general business (as demonstrated by bank practice) is the acquisition and holding of tax-exempt obligations. Under this interpretation, an allocable portion of deposits accepted in the general course of business should be considered to have been accepted for the purpose of investing in tax-exempt obligations, and the deduction for that portion should be disallowed.

The Administration proposal would deny financial institutions a deduction for an allocable portion of interest paid on deposits and other indebtedness, equivalent to the portion of the institution's assets which is invested in tax-exempt obligations. This approach avoids tracing problems and is comparable to the treatment accorded under present law to dealers in tax-exempt obligations (other than banks) who borrow money for the general purpose of conducting a general brokerage business, including the acquisition and holding of tax-exempt and non-tax-exempt obligations. However, in the case of dealers, a tracing rule is applied where interest is directly related to the acquisition or holding of tax-exempt obligations (resulting in disallowance), or to certain other purposes, e.g., acquiring or improving physical facilities (resulting in allowance of related interest deductions); proportional allocation applies only to interest which cannot be differentiated between different purposes.[45] Thus, the law takes into account the particular situations of different dealers. By applying a proportionate disallowance to all interest deductions by financial institutions, the Administration proposal would deny this flexibility. However, in the absence of a proportionality rule, the problems of assessing a bank's "purpose" in accepting deposits would remain as under present law.

Tax equity

Aside from revenue considerations, a major argument against present law is that it prescribes differing treatment for financial institutions and other taxpayers. By using deposited funds to purchase or carry tax-exempt obligations, banks are able to enjoy the benefits of receiving tax-exempt investment income and paying tax-deductible interest on the same or equivalent funds—precisely the double benefit which is denied to other taxpayers. The volume of tax-exempt obligations held by banks (currently about one-third of all such obligations) indicates that banks have made extensive use of deposited funds to acquire and hold tax-exempts. This situation has contributed to the relatively low effective tax rates paid by banks since, by deducting the interest on debt used to purchase tax-exempt obligations, a bank can "zero out" its taxable income by investing a relatively small percentage of its assets in tax-exempt obligations. For example, even allowing for the 20 percent "cutback" on tax preferences, a bank that earns an average return of 10 percent on its taxable assets and pays an average of 8 percent on deposits would pay no tax if it invested approximately 24 percent of its assets in tax-exempt obligations. The disallowance of interest deductions also may lead to economic inefficiency, since a bank may have an incentive to hold tax-exempt obligations even when they pay substantially less interest than the bank pays to its depositors. Banks have maintained that they merely are passing through the benefits of tax exemption in the form of lower interest rates and that these reduced interest rates are a form of implicit tax on the banks.

---

[43] As used in this analysis, the term "banks" refers to all taxable financial institutions. Of tax-exempt obligations held by financial institutions, the great majority are held by commercial banks.

[44] Banks may argue that deposits are distinguished from most other forms of debt, since they are (1) for an unspecified period, and (2) terminable at the will of the depositor, but not of the bank. *See, Investors Diversified Services, Inc. f. United States*, 573 F.2d 843, 853 (Ct. Cl. 1978.) This argument is obviously less applicable for time deposits.

[45] *See* Rev. Proc. 72-18, 1972-1 C.B. 740; *Leslie v. Comm'r*, 413 F.2d 636 (2d Cir. 1969), *cert. den.* 396 U.S. 1007 (1970).

A particular problem under present law is the use of tax-exempt obligations as collateral for deposits or other short-term bank borrowing. By using tax-exempt obligations as collateral, a bank receives tax benefits when it is really the depositor (who may be tax-exempt or have a low marginal tax rate) who is lending to the issuing government. State and municipal deposits in particular are frequently collateralized with tax-exempt obligations, sometimes of the same State or municipality;[46] in these cases, the Federal government subsidizes a transaction in which there may be no net borrowing by the State or local government. Rev. Proc. 80-55, 1980-2 C.B. 849, would have disallowed a deduction for interest paid by commercial banks on certain time deposits made by a State and secured by pledges of tax-exempt obligations; however, this revenue procedure was subsequently withdrawn.[47]

An essential difference between the present law treatment of financial institutions and other taxpayers is that opposite presumptions are applied to each group. Thus, under Rev. Proc. 72-18, a rebuttable presumption exists that an individual has the purpose of carrying tax-exempt obligations when the relevant indebtedness is not directly connected with personal expenditures and is not incurred or continued in connection with the active conduct of a trade or business. Corporations face a similar negative presumption when they borrow in excess of reasonable business needs. In contrast, banks are subject to disallowance of interest only when "*unusual facts and circumstances outside of the normal course of*

---

[46] State or local law frequently requires that State and municipal deposits be collateralized with obligations of specified governmental bodies. These may include taxable or tax-exempt obligations.

[47] Rev. Proc. 80-55 is discussed further below.

business . . . demonstrate a direct connection between the borrowing and the investment in tax-exempt securities." Rev. Proc. 70-20, 1970-2 C.B. 499, 500 (emphasis supplied). The law thus creates a presumption that debts incurred in the normal course of the banking business (including all or nearly all deposits) are *exempt* from the disallowance provision. This contrasts in particular with the treatment of dealers in tax-exempt securities, who are presumed to have used a ratable portion of untraceable funds for the purpose of acquiring or holding tax-exempts.[48]

The Administration proposal would eliminate the current advantage enjoyed by financial institutions, by denying a deduction for that portion of interest payments which is equivalent to a bank's tax-exempt holdings. Supporters argue that this would result in equal treatment and a "level playing field" between banks and other taxpayers. Banks, however, have argued that the rule would discriminate unfairly against them, since they would be subject to an automatic (albeit proportional) disallowance, while other taxpayers would be dealt with on a facts and circumstances basis. One possible response to this would be to apply a proportional disallowance to all taxpayers, or at least to all corporations, including dealers in tax-exempt securities. A flat proportional rule, however, would be difficult to administer for many taxpayers, and could lead to harsh results in certain cases, e.g., denial of a portion of individual (or corporate) mortgage deductions because the taxpayer held some tax-exempt obligations. Another approach would be to disallow all deductions on interest which is traceable to tax-exempt obligations, allow deductions on interest traceable to other purposes (e.g., mortgage interest), and apply a proportional rule to remaining (untraced) interest—a "three basket" approach similar to that currently applied to broker-dealers. This approach, however, is the most complex of all, and leaves the question of whether any of a bank's (or other taxpayer's) funds can ever accurately be traced.

State and municipal finance

Tax-exempt bonds are a major source of financing for State and municipal governments. Financial institutions (primarily commercial banks) presently hold about one-third of outstanding tax-exempt bonds, although this percentage has declined somewhat in recent years.

Legislative history indicates a Congressional concern that, if banks were denied an interest deduction in proportion to their tax-exempt holdings, the banks would eliminate or substantially reduce their investments in tax-exempt bonds. The Senate Finance Committee in 1934, rejecting a proposed change in the rule, expressed the opinion "that the change made by the House bill will seriously interfere with the marketing of government securities, which are bought for the most part by banks and financial institutions, and also presents grave administrative difficulties."[49]

---

[48] According to Rev. Proc. 72-18, where indebtedness is incurred for the general purposes of conducting a brokerage business, "it is reasonable to infer that the borrowed funds were used for all the activities of the business which include the purchase of tax-exempt obligations." Accordingly, section 265(2) of the Code is applicable in such circumstances. Rev. Proc. 72-18, 1972-1 C.B. 740, 742.

[49] S. Rep. No. 558, 73d Cong., 2d Sess. 24 (1934).

In 1980, when the Internal Revenue Service issued Rev. Proc. 80-55, *supra*, banks and various State and local governments protested that the disallowance of deductions on the deposits in question would depress the market for tax-exempt bonds, making it more difficult for States and municipalities to raise needed funds. (It was also argued that the revenue procedure was inconsistent with previous interpretations of the disallowance provision.) The IRS revoked Rev. Proc. 80-55 in April 1981.

The denial of interest deductions is one of several aspects of the Administration proposal affecting the tax-exempt bond market. Other proposals include the elimination of nongovernmental tax-exempt bonds and the application of tightened arbitrage and advance refunding restrictions to all tax-exempt obligations.[50] The combined effect of these proposals would be to reduce the volume as well as the attractiveness (at least to financial institutions) of tax-exempt bonds generally. However, certain aspects of the proposal could potentially offset one another. For example, while disallowance of bank interest deductions (coupled with reduced marginal rates) would tend to reduce demand for tax-exempt bonds (especially short-term obligations) and thereby increase yields, the elimination of nongovernmental bonds would arguably increase demand for remaining "public purpose" bonds, and thereby have an opposite effect.[51] Stated differently, there would be fewer taxpayers wanting to hold tax-exempt bonds, but there would also be fewer tax-exempt bonds to hold. How one views this situation depends on one's view of the costs and benefits associated with tax-exempt bonds, generally.[52]

One likely result of the Administration proposal is at least some shift in tax-exempt bond ownership toward individuals, and away from financial institutions. Banks have argued that the effective date of the provision should be adjusted to exempt obligations originally issued (as opposed to obligation acquired) before 1986, which they suggest would minimize the incentive to sell existing obligations and the potential effect of such sales on the tax-exempt market.

---

[50] *See*, Joint Committee on Taxation, *Tax Reform Proposals: Tax Treatment of State and Local Government Bonds* (JCS-23-85), July 16, 1985, pp. 43–46.

[51] *See*, Administration Proposal, p. 245.

[52] These issues are discussed further in the pamphlet regarding tax-exempt bonds, referenced in note 50, *supra*.

C. Special Rules for Reorganizations of Financially Troubled Thrift Institutions

Present Law and Background

In 1981, Congress added several provisions to the tax Code that were designed to facilitate acquisitions of financially troubled thrift institutions by financially stronger institutions.[53] These provisions were enacted at a time when many thrift institutions were experiencing financial difficulties as a result of having extended long-term mortgage loans to borrowers, while at the same time being forced to pay high interest rates on short-term deposits. In some cases, the institutions were forced to merge into other institutions to resolve their financial problems. In connection with these mergers, the Federal Savings and Loan Insurance Corporation (FSLIC) frequently would contribute money to the acquiring organization (or the financially troubled institution) as an inducement to the acquisition.

Continuity of interest requirement

It had been unclear under prior law whether a merger of one thrift institution into another could satisfy the judicially-created "continuity of interest" requirement. The continuity of interest doctrine generally requires that the shareholders of an acquired corporation maintain a meaningful ownership interest in the acquiring corporation in order for the transaction to qualify as a tax-free "reorganization" within the meaning of section 368(a).[54]

Because of the unusual nature of despositors' interests in thrift institutions, there was considerable uncertainty under what circumstances the depositors of an acquired thrift would be deemed to have a substantial equity interest in the acquiring institution.[55] If the transaction failed to qualify as a reorganization, the acquiring corporation would take a cost basis in the acquired thrift's assets, rather than assuming the thrift's basis. In many cases, a carryover basis was desirable because the thrift's basis in its assets exceeded their fair market value.

---

[53] Secs. 235-238 of Pub. L. 98-34, 97th Cong., 1st Sess. (1981), referred to as the Economic Recovery Tax Act of 1981 (ERTA).

[54] *See Penellas Ice & Cold Storage Co.* v. *Commissioner*, 287 U.S. 462, 468-470; Treas. Reg. sec. 1.368-1(b), 1.368-2(a).

[55] In Rev. Rul. 69-3, 1969-1 C.B. 103, the Service ruled that a merger of a mutual savings and loan association into another mutual savings and loan association qualified as a tax-free reorganization. A recent decision by the Supreme Court, however, held that a merger of a stock savings and loan into a mutual savings and loan failed to qualify as a tax-free reorganization. The Court held that continuity of interest did not exist because the depositors in the acquired institution (whose savings accounts were converted into accounts in the acquiring institution) received essentially cash plus an insubstantial equity interest. *Paulsen* v. *Commissioner*, 105 S. Ct. 627 (1985). The legislative history of the 1981 amendments made it clear that the provision covered all possible combinations of stock and mutual thrift institutions, including stock acquiring mutual, stock acquiring stock, mutual acquiring mutual, and mutual acquiring stock.

In addition, if the transaction qualified as a tax-free reorganization, the acquiring institution would generally succeed to the acquired thrift's net operating loss carryovers, subject to certain limitations in section 382.[56]

Under the 1981 amendments, the continuity of interest requirement need not be satisfied in the case of a merger involving thrift institutions, provided certain conditions are met. First, the acquired institution must be one to which section 593 applies, namely, a savings and loan association, a cooperative bank, or a mutual bank. Second, the FSLIC or the Federal Home Loan Bank Board (FHLBB) (or, if neither has jurisdiction, an equivalent State authority) must certify that the thrift is insolvent, that it cannot meet its obligations currently, or that it will be unable to meet its obligations in the immediate future. Third, substantially all of the liabilities of the transferor institution (including deposits) must become liabilities of the transferee. If these conditions are satisfied, the acquired institution need not receive or distribute stock or securities of the acquiring corporation for the transaction to qualify as a tax-free reorganization (sec. 368(a)(3)(D)).

In addition, in applying the loss limitation provisions of section 382, deposits in the acquired corporation that become deposits in the transferee corporation are treated as stock of both corporations.

FSLIC contributions to savings and loan associations

Although contributions to capital by nonshareholders are excluded from the income of the recipient corporation (sec. 118), the basis of property normally must be reduced by such contributions (sec. 362(c)). The 1981 Act, however, provided that certain financially troubled thrift institutions need not reduce their basis for money or property contributed by the FSLIC under its financial assistance program (sec. 597(b)).

Administration Proposal

The Administration proposal would repeal the special rules relating to acquisitions of financially troubled thrift institutions and the exclusion from income of FSLIC payments to such thrifts. The repeal of the reorganization rules would take effect on a delayed basis, however. The repeal be effective for acquisitions or mergers occurring on or after January 1, 1991. The exclusion for certain FSLIC payments would be repealed for taxable years beginning on or after the same date, although an exception would be provided for payments made pursuant to an agreement entered into before that date.

Analysis

In support of its proposal to repeal the special reorganization rules applicable to financially troubled thrifts, the Administration argues that these rules simply provide an indirect Federal subsidy to thrift institutions. To the extent acquiring institutions are permitted to realize tax benefits that are otherwise unavailable (for example, because continuity of interest is not maintained in the transaction) in exchange for assuming the obligations of a failing thrift, the Federal Government is in effect making payments to the thrift or its successor. The burden of these payments properly belongs on the FSLIC's member institutions, who presumably would pay higher insurance premiums absent the tax subsidy. If subsidies to the thrift industry are necessary, the Administration argues, they should be done directly through the appropriations process.

---

[56] Under section 382, the ability of an acquiring corporation to succeed to the net operating loss carryovers of a corporation acquired in a reorganization is limited to the extent the owners of the acquired corporation fail to acquire stock in the acquiring corporation representing at least 20 percent of the value of the latter's stock (sec. 382(b)).

Opponents of the proposal, while conceding that these special rules will be unnecessary if thrift institutions have fully adjusted to a deregulated environment, argue that a reexamination of the need for the rules in five years is preferable to a provision requiring a definite "sunset" in 1991. In the financial markets are unstable at that time and interest rates are high, some special incentives for mergers of financially troubled institutions with stronger institutions may be necessary. In addition, some argue that in the meantime, the rules should be amended to clarify that financial assistance payments to thrift institutions by the Federal Deposit Insurance Corporation (in addition to payments by the FSLIC) qualify for the exclusion under section 597.

The special treatment accorded to financially troubled thrift institutions undergoing a merger may serve as a significant incentive to another institution to acquire an ailing thrift. An acquisition by an ongoing, healthy institution may avoid the disruptive and costly process whereby the FSLIC is forced to take control of the thrift and satisfy its obligations to depositors. On the other hand, in order to avoid this result, the Federal Government must concede what may amount to substantial tax benefits to the acquiring institution in the form of higher basis in assets and net operating loss carryovers. The relevant inquiry is which approach is the more efficient means of accomplishing the desired objectives.

One could argue that it is inappropriate as a matter of tax policy to accord savings and loans and their depositors more favorable treatment than other business enterprises in a similar situation. If there are other reasons for granting Government subsidies to thrift institutions, it may be more appropriate to provide these subsidies on a case-by-case, direct appropriation basis, rather than through a wholesale exemption from the generally applicable reorganization rules. A direct subsidy approach might allow targeting of the relief to those situations where it would be most cost-effective and beneficial, and would make it easier to verify the true cost of the such subsidies.

D. Credit Unions

Present Law and Background

Credit unions are exempt from Federal income tax under present law. This exemption applies regardless of whether, or to what extent, income of the credit union is distributed as dividends. Both State and Federally chartered credit unions are exempt from tax.

State chartered credit unions have always been exempt from Federal income tax. Until 1951, the tax exemption for these credit unions was subsumed under the tax exemption for savings and loan associations. When the exemption for savings and loan associations was terminated as part of the Revenue Act of 1951, the exemption for credit unions was continued in a separate Code provision (sec. 501(c)(14)). This provision grants an exemption for credit unions without capital stock and which are organized and operated for mutual purposes and without profit.

Federally chartered credit unions were originally authorized by the Federal Credit Union Act of 1934. The tax exemption for these credit unions is specified by section 122 of the Federal Credit Union Act (12 U.S.C. sec. 1768). Under this provision, Federal credit unions are also exempt from State and local taxation, except for taxes on real and tangible personal property.

Administration Proposal

The Administration proposal would repeal the Federal income tax exemption for credit unions having assets of $5 million or more. These credit unions would be subject to the same tax rules as would apply to thrift institutions (e.g., savings and loan associations and mutual savings banks).[57] Under this proposal, retained earnings of a taxable credit union (i.e., earnings not distributed as dividends to members) would be subject to tax at the credit union level, while dividends would be taxable to the individual members. The proposal would be effective for taxable years beginning on or after January 1, 1986.

Other Proposals

1984 Treasury Report

The 1984 Treasury report recommended repealing the tax exemption for all credit unions.

---

[57] For proposed amendments which would limit thrift institutions and credit unions to the specific charge-off method of computing bad debt deductions, see Part II.A.2, above.

S. 409 and H.R. 800 (Bradley-Gephardt)

The Bradley-Gephardt bill would repeal the tax exemption for all credit unions, effective for taxable years beginning on or after January 1, 1987.

Analysis

Credit unions were orginally exempted from tax, together with savings and loan associations, because both credit unions and savings and loan associations operated on a "mutual" basis (that is, on behalf of and for the benefit of their members), and not as separate profit-seeking entities. Because of this structure, it was thought that the income of these entities should be taxed only when distributed to the members. In addition, credit unions were generally small, unsophisticated financial institutions, operated by volunteers.

In 1984, Federal credit unions[58] earned approximately $5.1 billion in net income, of which approximately $4.4 billion was paid out in dividends and interest to member-depositors. Undistributed net income of Federal credit unions (after subtracting dividend and interest payments and reserve transfers) increased from $34 million in 1975 to $476 million in 1984.[59] While many credit unions remain small, there are today also many relatively large credit unions, and credit unions offer an array of services that are not always distinguishable from those offered by banks and taxable thrift institutions. Other mutual financial institutions which compete with credit unions, including mutual savings banks, are subject to tax on income not paid out as dividends to their member-depositors. These and other competing institutions may be at a disadvantage with respect to credit unions, which can accumulate tax-free income (and interest on that income). Some argue, therefore, that the credit union exemption should be reconsidered and credit unions be treated the same as taxable thrift institutions.

Credit unions representatives argue that credit unions are unlike other financial institutions because they continue to be more closely controlled by, and responsive to, their members. For example, the law requires that most directors of a Federal credit union receive no compensation, and forbids proxy voting in credit union elections. While no longer subject to interest rate limitations, Federal credit unions may lend only to credit union members[60] (or other credit unions) and only for consumer (i.e., nonbusiness) purposes. These requirements, it is argued, ensure that credit unions will act in the direct interest of their members and distinguish them from other, profit-seeking entities. It is further argued that credit unions make loans available to small depositors who would not otherwise qualify for such credit.

---

[58] As of 1984, there were 10,547 active Federally-chartered credit unions and approximately 7,800 state-chartered credit unions. Of the state credit unions, 4,657 were Federally insured. See National Credit Union Administration, *NCUA 1984 Annual Report*, pp. 35, 39; Credit Union National Association (CUNA), *1984 Credit Union Report*.

[59] *NCUA 1984 Annual Report*, pp. 34, 36-37.

[60] Credit union membership must generally be based on some "common bond" between the members, e.g., a common employer or residence in a designated geographic area. Membership may qualify an individual for loans substantially in excess of the amount contributed to (i.e., deposited with) the credit union.

The Administration proposal would retain the tax exemption for credit unions having less than $5 million of gross assets. The proposal states that this would result in taxation of approximately 80 percent of retained earnings of credit unions, while leaving more than four-fifths of all credit unions (that is, the smaller credit unions) untaxed.[61] (Because membership, as well as assets, is concentrated in larger credit unions, the repeal would affect a relatively high proportion of credit union members.) The proposal further indicates that the $5 million threshold would avoid administrative difficulties for smaller credit unions. However, credit union representatives have suggested that taxing the larger credit unions would harm smaller institutions as well, by reducing the capitalization level of the credit union movement and initiating a trend toward more "profit-driven" (and possibly more risky) investment.

If Congress wishes to repeal the general credit union tax exemption, while retaining some protection for smaller credit unions, it may wish to consider exempting a specified amount of income of any credit union from tax, and imposing tax only on the excess over this amount. While somewhat more complex adminstratively, this would avoid the "cliff" which occurs in the Administration proposal (i.e., credit unions below $5 million in assets remain exempt from tax, while those just above $5 million must pay tax on their full retained earnings). Congress may also wish to consider "phasing in" the taxation of some or all credit unions over a multiyear period.

---

[61] This proposal is found on pp. 247-248 of the Administration Proposal.

○

The CHAIRMAN. The hearing will come to order, please.

This morning we are hearing testimony involving two areas: financial institutions and mining, minerals, and related industries. Needless to say, I am well familiar with the problems that the President's bill causes to both of those industries, and I have some sympathy to many of the complaints that I have read in your testimony.

I have read all of the testimony that was in, and it was all here in timely fashion; so I would encourage you to abide by our 5-minute rule today, put your testimony in the record—it will be in there completely—and limit yourselves to 5-minute oral presentations so that I and the other members who came can ask you questions.

We will start with a panel composed of Mark Olson, the president-elect of the American Bankers Association, Mr. Finn Caspersen, chairman of the board, Beneficial Corp.; Joe Morris, president, Columbia Savings Association; W. Dean Cannon, president of the California League of Savings Institutions; and Joseph Perkowski, the president of the Minneapolis Federal Employees Credit Union.

Mr. Olson, why don't you start?

STATEMENT BY MARK N. OLSON, PRESIDENT-ELECT, AMERICAN BANKERS ASSOCIATION, FERGUS FALLS, MI ACCOMPANIED BY GORDON F. MARTIN, CHAIRMAN, TAXATION COMMITTEE, AMERICAN BANKERS ASSOCIATION, NEW YORK, NY

Mr. OLSON. Thank you, Mr. Chairman.

I am Mark W. Olson, president of Security State Bank in Fergus Falls, Minnesota, and a member of the American Bankers Association board of directors. I am accompanied today by Gordon F. Martin, chairman of the ABA's taxation committee and administrative vice president and director of Taxes for Marine Midland Bank.

I am appearing here on behalf of the American Bankers Association. The ABA supports the concept of tax reform and would support a bill that reduced tax rates, broadened the tax base, removed taxes from investment decisions, and promoted fairness.

The President's proposal contains many of these features but unfortunately contains a number of provisions which are damaging to the banking industry. In our written testimony we discuss in detail all the provisions that affect banking and our specific concerns about each. At the outset, however, I want to indicate that modification to three of these provisions are essential to the banking industry.

We could not support a tax reform bill that does not contain these modifications:

The first of these is the preservation of a reserve for loan losses. Without a reserve, there is no way to properly match a bank's income and expenses. In addition, real reform in the calculation of the reserve could be achieved with the principle of book-tax conformity as contained in S. 1263, if S. 1263 is adopted.

The second modification is retention of the deduction for carrying charges on tax-exempt obligations issued before the date of enactment of any tax-reform measures. This would allow for a continuation of the inner-bank market for these tax-exempt obligations and thus ensure some liquidity for a bank experiencing financial difficulties.

The third modification is preservation of the existing foreign tax credit rules. U.S. and foreign banks compete in the international marketplace under generally similar tax rules. The President's proposal would place U.S. banks at a disadvantage. This would affect not only U.S. banks but many other U.S. businesses that depend on American banks to finance their overseas operations.

If any tax-reform initiative is enacted, it should address all of the above concerns.

In addition, the ABA believes that the changes should be phased in to prevent severe market shocks. We are very concerned about making abrupt massive revisions in the Tax Code where the economic effects cannot be measured.

As you consider our recommendations for change, I believe it is important to fully understand how banks are treated under current law. There are three elements that are important to remember here:

First, banks are usually subject to tax under the same rules as other taxable corporations.

Second, the tax benefit a bank receives from purchasing a tax-exempt bond or providing lease financing is, in general, passed directly to the city or State selling the bond or to the corporate lessee in the form of lower rates. That is what the tax-exempt market is all about. Our profits on these transactions do not vary significantly from our profits on similar taxable loans.

Third, banks pay over $2 billion annually into the Treasury as the result of the reserves they are required to maintain with the Federal Reserve. This indirect tax, which the Federal Reserve Governors have acknowledged as a tax, is in addition to the payment of the cost of regulation required by the Comptroller of the Currency and the Federal Deposit Insurance Corp., and the Federal Reserve System.

Mr. Chairman, I would urge the committee to examine fully our written statement, which contains our views on all of the major income tax provisions affecting banking in the President's program. We plan to submit a written statement on the trust tax issues.

We appreciate the opportunity to testify, and Mr. Martin and I would be more than happy to answer any questions you may have.

The CHAIRMAN. Thank you, sir.

Mr. Caspersen.

[Mr. Olson's written testimony follows:]

STATEMENT OF MARK W. OLSON ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION

I am Mark W. Olson, President of Security State Bank in Fergus Falls, Minnesota and a member of the American Bankers Association's Board of Directors. I am accompanied today by Gordon F. Martin, Chairman of the ABA's Taxation Committee and Administrative Vice President and Director of Taxes for Marine Midland Bank. I am appearing here on behalf of the American Bankers Association. The American Bankers Association is the national trade and professional association for America's Full Service Banks. The combined assets of its member banks represent approximately 95 percent of the industry's total assets. I would like to thank the Committee for this opportunity to testify.

Last year, in anticipation of the current activity in the area of tax reform, the ABA selected a task force of economists and tax executives from a cross-section of our membership. This task force was charged with the detailed examination of the various tax reform proposals and with assessment of the impact of such proposals on banks and the economy as a whole. The group examined the theoretical underpinnings of the reform proposals, as well as the technical applications of individual items. We studied the Bradley-Gephardt, Kemp-Kasten, Roth-Moore, VAT, and Brookings proposals. We spent several months studying the Regan Treasury proposal. Since May, our attention has been focused on the proposal made by President Reagan.

The American Bankers Association supports the concept of tax reform and would support a bill that reduced tax rates, broadened the tax base, removed taxes from investment decisions, and promoted fairness. The President's proposal contains many of these features but unfortunately, also contains a number of provisions that are damaging to the banking industry. Later in our testimony we discuss in detail all of the provisions that affect banking and our specific concerns about each. At the outset, however, I want to indicate that modifications to three of the provisions are, we believe, essential to the banking industry. We could not support a tax reform bill that does not contain these modifications. The first of these is the preservation of a reserve for loan loses. Without a reserve, there is no way to properly match a bank's income and expenses. In addition, real reform in the calculation of the reserve could be achieved if the principle of book/tax conformity as contained in S. 1263[1] is adopted.

The second modification is retention of the deduction for carrying charges on tax-exempt obligations issued before the date of enactment of any tax reform measure. This would allow for a continuation of the interbank market for these tax-exempt obligations and thus ensure some liquidity for a bank experiencing financial difficulties.

The third modification is preservation of the existing foreign tax credit rules. U.S. and foreign banks compete today in the international market place under generally similar tax rules. The President's proposal would place U.S. banks at a disadvantage. This would affect not only U.S. banks but many other U.S. businesses that depend on American banks to finance their overseas operations.

If any tax reform initiative is enacted, it should address all of the above concerns. In addition, the ABA believes that changes should be phased in to prevent severe market shocks. We are very concerned about making abrupt, massive revisions in the tax code where the economic effects cannot be measured.

We are particularly concerned over the ability to assess the economic effects of the President's proposal—or any of the others—on the total economy. It is extremely difficult to assess the overall economic effects of such sweeping, system-wide tax reforms, although we find several of the individual ideas in the proposal worthwhile. The proposed changers may have unforeseen effects which neither econometric studies nor informed judgments can detect. The changes are to many and too varied for the econometric models to accurately evaluate. Because of this problem, we would urge the Congress to be cautious in making changes of such magnitude.

Before beginning my discussion of the specific proposals in the President's plan affecting banking, I would like to discuss the role banks play under the current system. An understanding of that role is necessary to fully appreciate the effects of tax reform on banks.

We believe there are three important elements to the way banks are currently taxed. First, banks are generally subject to tax under the same rules as other taxable corporations. Second, the tax benefit a bank receives from purchasing a tax-exempt bond or doing a finance lease is passed directly through to the city or state selling the bond or to the corporate lessee. In general, a banks profit on such transactions varies little from its profit on a straight taxable loan. Third, banks pay over $2 billion annually into the Treasury as a result of the reserves they are required to maintain with the Federal Reserve System. This quasi-tax is in addition to paying all of the costs of regulating banking incurred by the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Federal Reserve System. It is the combined effect of these three elements that determines a bank's true effective tax rate. A survey conducted on 1983 income by the Bank Administration Institute asked banks to recalculate their taxes to reflect the earnings of Treasury on the reserves provided to the Federal Reserve System and a tax equivalent analysis of municipal bond income. The result was an effective tax rate of 43 percent.

---

[1] Introduced by Senators Bill Roth (R-DEL) and David Boren (D-OKLA).

By purchasing tax-exempt bonds and engaging in leasing transactions, banks are fulfilling the role Congress has encouraged them to perform, that of financial intermediary, a transfer agent through which tax benefits flow to others. This means that a bank's profits would not be significantly decreased or increased if it ceased being a transfer agent. Any changes to this role might increase the effective tax rate of banks, but the real economic burden would be on the state and local governments, school boards, and businesses that would no longer be able to borrow at reduced rates.

The Joint Committee on Taxation staff has recognized the effect this role has on banking's effective tax rate. In their 1983 pamphlet discussing the way banks are taxed they stated, "To the extent that these investments by banks earned a lower pre-tax rate of return than comparable but fully taxable investments, it may be argued that the banks did bear an indirect economic burden attributable to the income tax apart from the actual tax payments they made."

All banks must post reserves with the Federal Reserve System on an interest-free basis in direct ratio to their transaction accounts and nonpersonal time deposits. The reserves held by the Federal Reserve System are then invested primarily in government securities. While this is not thought of as a tax—because it directly generates revenue that is brought into the Treasury as miscellaneous receipts—it clearly represents a financial contribution by the banking industry to the revenues available to pay the direct costs of government. As indicated above, the annual earnings on their reserves over the last few years has averaged over $2 billion. In 1980 and 1981, it reached a high of $3 billion.

Banking receives no benefit from this quasi-tax. The costs associated with the Federal Reserve's regulatory and service activities are taken out before any funds are transferred to the Treasury. The fund needed by the Federal Deposit Insurance Corporation and the Comptroller of the Currency to regulate banks are paid directly to those agencies by the industry. They do not come out of general Treasury revenues.

The view that the earnings on the reserves represent a quasi-tax is shared by the Chairman of the Federal Reserve Board, Paul Volcker. In a 1983 statement to the Senate Banking Committee he said, "Reserve requirements, while imposed for monetary policy purposes, also, from the viewpoint of the depository institution, represent a form of tax."

While the role of banks as financial intermediaries and the quasi-tax paid through the Federal Reserve System are very important to an accurate understanding of bank taxes, it must also be remembered that, in general, the same tax rules that apply to other taxable corporations also apply to banks. There seems to persist, however, a belief that banks must benefit from a number of "special" provisions in the Tax Code. This belief appears to be the result of the various studies claiming to show that the effective tax rate of banks is very low. An examination of the tax law for those features that are important in studies of effective tax rates reveals that, by and large, "special provisions" or "tax preferences" designed for banks are not involved. Instead, the single most important factor in reducing the Federal income taxes paid by banks is the exemption from Federal income tax of interest paid by state and local governments on their obligations. Another large component of the reduction for major institutions is the credit allowed for foreign taxes imposed by other countries on income earned by the taxpayer in those countries. A third large component is the combined effect of the investment tax credit and depreciation deductions from equipment leasing operations. None of the tax reducing effects of these provisions of the Federal tax law is attributable to the enjoyment of a special provision by banks.

The one provision in the Tax Code that might be labeled a "special provision" is Section 585 which sets out the rules by which banks calculate their loan loss reserve. While some have claimed that this provided banks with an artificially high deduction in the past, that clearly is no longer the case. Many banks, from the largest to the smallest, are currently limited to deducting the debts that were charged-off during the year. These banks maintain a reserve, but the "special provision" applicable to banks prevents them from adding to the reserve the losses that are inherent in their loan portfolios but not yet charged off. Other corporations are able to use methods which do, we believe, allow a significantly higher bad debt tax reserve level than banks are currently allowed. Even in the past, however, the loan loss reserve was never a major component of the reduction of Federal income taxes for banks. We discuss our reaction to the President's proposal on bad debt reserves later in this testimony.

To fully appreciate the effect of the current tax system on banking, it is also useful to look at the way other financial institutions are taxed. Achieving a level playing field for all financial institutions was one of the Treasury Department's original goals for tax reform. The Treasury Department stated that the tax preferences of financial institutions ". . . create distortions within the financial sector that are inconsistent with the Administration's efforts to deregulate financial markets. Equity and neutrality demand that all financial institutions be taxed uniformly on all of their net income."

While we recognize that the issue of deregulation of financial markets is not before the Ways and Means Committee, changes in the tax law that would help to achieve this goal are of great importance to the nation's banking industry. The ABA has long supported the idea of a level playing field for financial institutions. To the extent the President's proposals help to achieve equal tax treatment, we applaud them. We do not agree, however, that all of the proposals would help to achieve this goal.

The President has proposed equal treatment of bad debt losses for depository institutions by seeking to repeal the reserve method of accounting. While this would achieve equality among dispository institutions, insurance companies would still be able to maintain reserves for their expected losses. We believe equal treatment demands that depository institutions as well as insurance companies be able to maintain reserves to protect against known but unidentifiable losses that are inherent in their portfolios.

In general, however, the proposals does achieve some measure of equal treatment for depository institutions. All depository institutions will be subject to the same rules for deducting bad debts and credit unions will be subject to tax. One difference that will remain until 1991, however, is the special tax rules for reorganizations of troubled thrifts. It is not our place to comment on whether these special rules should or should not be maintained. Whatever rules are finally adopted, however, should also be available for the reorganization of a troubled bank.

Another area where equal treatment is cited by Treasury is the proposal effecting the tax-exempt holdings of banks. We will talk later about our reaction to this specific proposal but we would like to point out here that it does not achieve equality of treatment. If the proposal is passed, banks would be subject to an absolute disallowance for their interest deduction in direct relationship to their holdings of tax-exempt obligations. Other financial institutions, however, would continue to be subject to the far less stringent rules of Section 265(2). That section requires the Internal Revenue Service to prove a direct link between the borrowing and the purchasing of tax-exempt obligations. We wonder how well Section 265(2) is being enforced, particularly when related parties are involved. Concern over this resulted in the Treasury Department being given regulatory authority to deal with this question in the 1984 Deficit Reduction Act. Until those regulations are issued, the concern will remain.

Finally, I would like to mention the issue of equal treatment of products. This has become an issue because of the attempts to tax the "insider build up" of life insurance policies. We would ask that in your deliberations you consider how close this product is to a savings account. The interest earned by both the bank account and the insurance policy can be left in to compound, can be taken out, or can be used as collateral for a loan. The interest on the bank account, however, is fully taxable.

With all of this in mind, let us now turn to a few of the changes proposed by the President. My comments today are not in any particular order and concern items which affect banks as corporations, financial intermediaries, employers and members of communities around the country. They do not include proposed changes to the trust and estate and gift tax areas. We hope to have the opportunity to present our views on those issues at a later date.

In light of current economic conditions, bank regulatory agencies are encouraging banks to increase their loan loss provisions in order to diminish the risk of severe economic reversals from the cumulative effects of nonperforming loans and an uneven economic recovery. Clearly, adequate reserves are necessary to ensure the safety and soundness of the banking system. Other taxpayers are allowed tax deductions for their normal business expenses. Since banks are required to maintain adequate reserves as part of their business operations, these expenses should also be allowed as tax deductions. The tax system should support this as a Federal policy goal.

Since 1921, all taxpayers have been allowed a deduction for reasonable additions to reserves for bad debts. The reserve method was originally proposed as a result of numerous conflicts over the arbitrary determinations on the part of taxpayers and the Internal Revenue Service as to when a debt was worthless and should be written off. Beginning in 1947, the Internal Revenue Service tried to provide some certainty to banks as to what would be considered a reasonable addition to the reserve for bad debts. Mimeograph 6209, 1947-2 C.B. 26 provided a formula in which the maximum reserve was based on a 20 year moving average, including the current year, of total net chargeoffs to total loans. In 1954, the IRS supplemented this mimeograph with Revenue Ruling 54-148, 1954-1, C.B. 60 which provided that a bank could choose to compute its reserve using an average experience factor based on any 20 consecutive years after 1927.

By 1965, the IRS was again reexamining the formula and issued Revenue Ruling 65-92, 1965-1 C.B. 12. This ruling provided a uniform reserve ceiling of 2.4 percent of loans outstanding, with certain exceptions. As an alternative to the percentage method a bank was allowed to compute its reserve using an experience factor based on a six year moving average.

Congress codified the IRS rulings for the first time in the Tax Reform Act of 1969. In the belief that banks enjoyed more favorable bad debt reserves than most taxpayers, new Section 585 of the Internal Revenue Code provided that the percentage method be phased out completely by December 31, 1987.

The President's proposal would repeal Section 166(c) of the Internal Revenue Code, which allows a taxpayer to deduct business bad debts by using the reserve method of accounting. This includes repeal of Section 585 which dictates how a commercial bank must compute its annual reserve addition. All taxpayers would be required to use the specific charge-off method.

One of the reasons the President's proposal gives for proposing the change to the specific charge-off method is that the ". . . tax system encourages lenders to make risky loans". This is analogous to saying a lender will risk losing one dollar on a bad loan in order to get thirty-three cents in tax benefits. If business decisions were actually made on this basis, every business in this country would go bankrupt.

The President's proposal goes on to state that one of the practical effects of present law is ". . . to enable depository institutions to offer loans at artificially low rates". It should be noted that for the most part interest rates are based on world market conditions and the cost of funds to the institution. In addition, banks have sometimes been unfairly accused of keeping interest rates on loans artificially high even though the rates are determined by the marketplace. This seems inconsistent with the Federal policy of trying to keep interest rates down.

The use of net charge-offs also may put greater pressure on a bank to foreclose on borrowers sooner rather than give them a chance to work out their problems. One can easily see the negative effects this change in policy would have on a section of the economy, such as farming, that is experiencing financial difficulties.

Waiting until a loan has been charged off to take a bad debt deduction will result in a mismatching of income and expense. The losses inherent in any loan portfolio do not occur all at once. They occur gradually over the life of the portfolio. In calculating the book reserve, a bank recognizes that gradual decline and attempts to measure only the decline in the value of the portfolio for a particular period of time. No attempt is made to calculate the future losses that may occur.

A bank is taxed on the annual income it receives from a loan portfolio. Under an accrual accounting system, the income is taxed whether or not it is actually received by the bank. In order to properly match the bank's expenses with the income, the banks must be allowed a deduction for the decline in value of the portfolio.

This mismatching occurs with a bank on the cash method as well. While income is limited to interest actually received the decline in the value of the underlying principle still needs to be recognized.

The gradual decline in the value of the portfolio is real. If a bank sells a loan portfolio, the purchase price would not be based on either the full value of the future charge-offs or the face value of the loans. Rather, the selling price would reflect the decline in value at that point in time. We are not asking to deduct the full value of future charge-offs in the year loans are made. It is equally inequitable to require a bank to wait until the end of the loan period to take the deduction.

In looking at the tax treatment of bad debts in other countries, the overriding majority of countries allow the reserve method of accounting. In a 1983 study prepared by Peat, Marwick, Mitchell & Co., twenty seven countries were reviewed as to the allowable tax treatment for bad debts. Of the countries reviewed, only Australia and Venezuela limit the deduction to specific charge-offs. Therefore, by requiring the specific charge-off method in the U.S., the U.S. tax system would be out of line with most of our major trading partners.

Over the years the IRS tried to find a formula for computing a reasonable addition to the reserve for bad debts. Experience has shown that these fixed formulas distorted appropriate deductions over a period of time; at times too high, at times too low. The Administration is now proposing that we go back to laws in effect prior to 1921 in that only specific net charge-offs be llowed as deductions. This idea does not appear to be any better as a solution now than it was then.

It would seem that the correct answer is book/tax conformity. Senator Bill Roth (R-Del) and Senator David Boren (D-Okla) have introduced a bill, S. 1263, that would allow a deduction for tax purposes for additions to a bad debt reserve if the amount is also claimed as a charge against earnings for financial statement purposes. No deduction would be allowed for additions to a book reserve which is in excess of 1.5 percent of total loans. There are also limitations which would ensure that any adjustment required to bring the book and tax reserves into conformity will be done gradually over a period of years.

This is not an open ended invitation to banks to derease their tax liability. One of the major responsibilities of bank management is to maximize earnings. At a 33 percent marginal tax rate, bank management would not be interested in artificially reducing earnings by 1 dollar to get a 33 cent tax benefit.

In addition, there are a number of different regulatory authorities looking at the reserves established by a bank. The banking regulators are concerned not only with the level of the reserve but whether the bank has sound procedures in place for regularly reviewing their loan portfolio. The banking regulators would be very concerned with any bank that greatly increased its loan loss reserve whenever it was making substantial profits.

The Securities and Exchange Commission (SEC) would also be looking closely at any bank that suddenly increased its loan loss reserve. They would be asking why if such an increase was necessary, the bank had not reported it earlier. They too would be looking to see if the bank had sound policies in place for examining its loan portfolio. Like the banking regulators the SEC, can, and does, impose substantial penalties in those instances where there is a violation of proper reporting procedures.

Generally Accepted Accounting Principles (GAAP) require that the adequacy of the loan loss reserve be determined on the basis of all relevant factors. These include but are not limited to, loss experience, changes in size and character of the loan portfolio, identification of problem situations which may affect a borrower's ability to repay a loan and evaluation of current economic conditions.

As indicated above, the book reserve is a measurement of the decline in value of a bank's loan portfolio. It is calculated using GAAP as recognized by the accounting profession. The use of the book reserve for tax purposes would recognize the differences between the loan portfolios of different banks. It represents the most accurate matching of loan loss expenses with income that can be achieved.

With certain exceptions not pertinent here, the Internal Revenue Code provides that interest earned on state and local obligations is exempt from Federal income tax. The tax-exempt income derived from investment in these assets is the largest single factor in reducing the nominal effective rate of Federal income tax for banks. It should be noted, however, that banks earn a lower rate of interest on these obligations. If the banks used those same funds to purchase taxable securities, the amount of Federal taxes paid would be higher but we doubt that the after tax rate of return would be any higher.

Banks purchase these obligations for a number of reasons that have little to do with the tax-exempt nature of the income from the investment. In many communities, particularly those with either no bond rating or an inferior rating, the banks of the community provide the only continuous, reliable source of financing for the local government. This is also true for the thousands of local school boards throughout the country. In other words, if the banks of the community would not agree to take a substantial portion of the obligations, where could they be sold—and at what price?

Bear in mind also that a substantial portion of the tax-exempt obligations issued by state and local governments are not long term bonds. They are, rather, revenue anticipation notes and other short-term obligations used to cover temporary shortfalls of cash when payments, including municipal payrolls, become due before periodic tax receipts have been received.

In addition to purchasing a certain number of these tax-exempt obligations in order to meet their responsibilities as good corporate citizens of their communities, banks purchase state and local obligations to assure themselves liquidity and to meet pledging requirements for public deposits in excess of insurance limits.

Under current law, no taxpayers, including banks, are allowed to deduct interest on debt directly incurred to purchase or carry tax-exempt obligations. However, based on various court decisions and IRS rulings, it has been determined that deposits accepted in the normal course of business, are not debt incurred to purchase or carry tax-exempt securities. This is only a presumption and where the IRS can show a direct linkage between borrowing and the purchase of the tax-exempt securities the issue of the disallowance of interest expense could be raised under Section 265(2).

In spite of the lack of any tie between accepting deposits from local governments and purchasing their bonds, banks are currently denied twenty percent of their interest deduction allocable to the purchase or carrying of tax-exempt obligations acquired after 1982. The allocable portion is presumed to be the ratio of tax-exempt assets to total assets. Under the President's proposal, banks would be denied a deduction for 100 percent of their interest charges allocable to the purchasing or carrying of tax-exempt obligations. The pro rata presumption would be irrebutable. This would apply to all obligations acquired after December 31, 1985. The current 20 percent disallowance would continue to apply to obligations acquired between January 1, 1983 and December 31, 1985. The ABA opposes this proposed change. The change puts banks at a decided disadvantage when compared to other taxpayers since a direct link between borrowing and the purchasing of tax-exempt securities is not the criteria used to determine the deductibility of interest expense.

The purchasing of tax-exempt obligations is not linked to deposit-taking activities of banks. These two functions are separate activities, related only in that they represent the two halves of banking; borrowing and lending. Without borrowing, there could be no lending; without lending, there would be no reason to borrow. Banks borrow from those who have extra funds and lend to those who need funds.

If Congress intends to change the banking industry's role as intermediaries in the municipal security market, the ABA believes the proposed denial of the deduction of interest to carry tax-exempt bonds should apply only to tax-exempt bonds issued after the enactment date. The proposal now calls for the denial to apply all tax-exempt bonds acquired after January 1, 1986. This change is consistent with the Administration's expressed desire to protect the tax treatment of past transactions. Banks purchase tax-exempt bonds with the understanding that they will be able to deduct 80 percent of the carrying costs, that the interest is tax-exempt and that a market exists to sell the bonds should the need arise. Banks also sell bonds with "puts", a written promise to buy the bond back at a stated price should the purchaser desire, on the same basis. This proposal should be limited to bonds issued after the effective date to protect these transactions. Without that protection, the interbank market for tax-exempts may cease to exist. Those banks that sold tax-exempts with fixed price puts would likely be facing significant losses if puts are exercised.

Like other U.S. taxpayers, banks that engage in international activities are subject to foreign taxes on income produced from such activities and are also subject to U.S. income tax on the same income. The foreign tax credit is the tax mechanism by which relief is obtained from the double taxation of the same income that would otherwise occur.

Currently law entitles U.S. taxpayers to take credit against U.S. taxes for taxes paid to foreign countries on income earned in those countries. The credit is determined by adding together all of the creditable taxes paid to all foreign countries. The credit that may be claimed, however, cannot exceed the total U.S. tax on the taxpayer's foreign source income. Thus, credits are not used to reduce U.S. tax on U.S. income. Under the President's proposal, credits available on foreign income would be determined on a per diem country basis. The taxpayer would have to determine the income earned in each country in which it did business. The credit would then be based on the taxes paid to each country but limited so that it could not exceed the U.S. tax on the income from that country. Losses could offset income in other countries, subject to recapture rules.

Foreign lending has become increasingly competitive in recent years. Foreign banks, especially those from strong-currency countries, are a major factor in dollar lending abroad. Up to now, U.S. banks have welcomed the increased competition—although admittedly with mixed feelings—as a sign of the health of the international banking system. As increased competition has narrowed profit margins for foreign lending, the foreign tax credit has become increasingly significant. In fact, if the foreign tax credit were not available. U.S. banks would have to increase interest charges in order to maintain an adequate return. Competition from other banks will not permit such pricing. The increased tax cost would put U.S. banks at a competitive disadvantage with foreign banks, whose costs would not be similarly increased, and might well force U.S. banks out of important overseas markets. Because of the role foreign loans play in financing the sales of United States commodities and products abroad, a reduction in the availability or utility of the foreign tax credit to commercial banks would have an adverse impact on U.S. trade, on our balance of payments, and even on domestic employment.

A substantial drop in the U.S. tax rate will, more than likely, result in an increase in excess foreign tax credits. These are credits that can't be used currently because the total foreign taxes paid exceeds the U.S. tax on the taxpayer's foreign income. The Administration apparently fears that this will result in corporations rushing to invest in countries with low tax rates, such as tax havens, in order to increase their foreign source income and the U.S. tax on that income, and thus be able to use more of their excess foreign tax credits. We do not believe this assertion is correct for American corporations in general, and it is clearly incorrect for American banks. A loan is made because someone has a need to borrow. Banks cannot create a need to borrow in residents of tax haven countries merely to take advantage of lower U.S. tax rates. In fact, tax haven countries generally have small domestic economies with no ability to absorb large investments. Instead, the effect of the Treasury proposal will be to limit lending to high tax countries. This will likely mean less involvement by U.S. bank in the international financial markets and a corresponding decline in U.S. international competitiveness and balance of trade.

The per country limitation would also be extremely cumbersome and complex to apply. It would require all foreign income to be traced to the country where the loan was made. This would be partricularly difficult for the banking industry because of the conduct of its business through a worldwide network of branches. Banks that are active in international finance often have hundreds, and in some cases, thousands of overseas branches. While some of these branches may be doing business in only one country, many of these branches, like the parent banks, are conducting banking operations in many countries. This is particularly true for branches operating in the major money centers of Europe, the Middle-East, and the Far-East. Trying to trace the income of all of the various branches to individual countries may well be an impossible task. For all of these reasons, the ABA opposes this change.

The President's proposal would require a business taxpayer to switch from the cash method of accounting to the accrual method of accounting, effective January 1, 1986, unless the business has: 1) annual average gross receipts of $5 million or less; and 2) used no other method of accounting to report income or loss in any other financial report.

The adjustment of affect the change would be computed by taking the difference between the previously unreported accrued income and accrued expenses as of December 31, 1985. This amount would be added to or deducted from taxable income over a period not to exceed six years.

Requiring banks to report on the accrual basis does not close loopholes or broaden the tax base. The proposed requirement also would operate unfairly in that all small businesses are not treated equally. Many banks have gross receipts under $5 million but all banks are now required to use the accrual method for regulatory repoorting purposes. The Administration apparently feels such taxpayers will find it simple to convert to the use of the accrual method for income tax purposes. This attitude fails to recognize the numerous differences between the accrual accounting rules for financial statements and those for income taxes. For example, the regulatory accural accounting rules, which in this instance are also used for financial statements, require banks to stop accruing interest on loans that are 90 days behind in paying interest while the IRS does not recognize any arbitrary cut-off.

In addition to the differences between accrual rules for financial statements and income taxes, there are currently many provisions in the Internal Revenue Code which are based on the cash method. These include, for example, reporting gains on the installment method and taxing prepaid income before it is earned.

The cash method of accounting has been accepted as "clearly reflecting income" over the years from 1913 to the present for businesses without inventories as long as the method is used on a consistent basis from year to year. Since the primary source of a financial institution's income is derived from the monthly payment of interest on loans, the cash basis method clearly reflects income on an annual basis. Therefore, we do not believe it is necessary for financial institutions to be required to use the accrual method of accounting.

Under current law, if a corporate taxpayer's items of "tax preference" exceed the greater of $10.000 or the regular corporate tax due for that year, a minimum tax of 15 peercent of the excess is imposed. The preference items include the amount by which a bank's loan loss reserve deduction exceeds actual experience. The President has proposed replacing this add-on minimum tax with an alternative minimum tax beginning January 1, 1986. The loan loss reserve preference item would be abolished since the deduction would be eliminated under the President's proposal. A new preference item would be added for borrowers: 25 percent of net interest expense deduction, but not more than the excess of the proposed Capital Cost Recovery System deduction over economic depreciation.

The ABA opposes the concept of a minimum tax. A minimum tax penalizes taxpayers for using the deductions and credits granted by Congress. The penalty occurs regardless of whether a drop in the regular income tax was a result of too many deductions or a decline in ordinary business receipts. The penalty can apply as a result of decisions made in prior years before a downturn in business. We fell minimum taxes are unnecessary in a properly designed, economically sound tax system.

Under current law, corporate taxpayers may generally carry net operating losses (NOLs) back three years or forward 15 years. Banks and thrift institutions, however, may carry NOLs back 10 years and forward 5 years. The Administration proposes to eliminate the special NOL rules applicable to financial institutions. Losses incurred before the effective date of January 1, 1986, would continue to be treated as under present law.

The ABA has no objection to this provision. Though some banks have not used up all of their 10 carry-back years, this change would not substantially impair the financial condition of those who currently benefit from these rules. It would also allow other institutions to benefit from the expansion of the carry-forward period and the general expansion of the number of carry-over years available.

Corporate tax rates currently are graduated from 15 to 40 percent for the first $100,000 of taxable income. Those rates are phased out for corporations with taxable income over $1 million. All other corporate taxable income is subject to a 46 percent rate. Under the President's proposal, the highest marginal corporate rate would be reduced to a 33 percent effective rate for tax years beginning on or after July 1, 1986. Graduated rates would be maintained, but only on the first $75,000 of income. The graduated rates would be phased out for corporate taxable income over $140,000. Corporations with taxable income over $360,000 would pay a flat 33 percent rate.

The ABA supports the reduction in marginal tax rates proposed by the President's plan. High tax rates reduce the incentive to work, save, and invest. One of the most important goals of tax reform must be to reduce the bias against savings and capital formation. A series of steps including reduction in marginal rates, expansion of IRAs (see below) and broadening of the tax base would move the tax system toward this objective. The lower rates should reduce the impact of taxes on investment decisions.

We are pleased to see the President rejected certain ideas contained in the Tresaury proposal dealing with the elimination of the graduated rate structure. The ABA feels the graduated rate structure is an important feature of our tax system, one that helps insure that small businesses do not pay a disproportionate share of the corporate tax pie.

The President's tax reform proposal contains a new tax on those who have responded to his capital incentives. Those taxpayers who have availed themselves of the provisions of the Accelerated Cost Recovery System—designed and enacted by this Administration—now find they will be penalized for having done what they were encouraged to do. Forty percent of the "excess" depreciation taken during the period January 1, 1980 to July 1, 1986 would be recaptured over a three year period beginning in 1986.

IN 1981, the Presidnent crafted a new cost recovery system, more generous than the previous one with larger depreciation deductions to encourage capital investment. Those who responded to these incentives, who made business decisions based on that new system now will have to "pay back" a portion of the difference between the deduction they received and what they would have received under a straight line depreciation system. The ABA opposes retroactive tax provisions. Though this would have minimal direct impact on banks, we oppose changes to the tax system which penalize taxpayers for investment decisions made in response to existing tax provisions.

Under current law, an individual generally is permitted to deduct annual contributions to an IRA of 100 percent of compensation or $2,000 whichever is less. Married individuals each receiving compensation during the year may make separate IRA contributions to their IRAs and claim a $4,000 deduction on their joint tax return. Special "spousal" IRA limits provide that if a married individual's spouse earns no compensation during the year the individual may deduct annual IRA contributions up to the lesser of 100 percent of compensation or $2,250. The spousal IRA is not available if the nonworking spouse has any amount of earned compensation.

The President's proposal would maintain the IRA dollar limits for individuals at $2,000 but would increase the spousal IRA limits from $250 to $2,000. The proposal would permit a nonworking spouse to take into account the working spouse's compensation (less the deductible IRA contribution made by the working spouse) in determining the nonworking spouse's deduction limit. Therefore, a married couple with aggregate compensation of $4,000 or more would be entitled to the same $4,000 IRA deductible contribution ($2,000 apiece) regardless of how much compensation was earned by either spouse. In so doing the importance of the economic contributions made by a nonworking spouse would be recognized.

The ABA believes that the tax benefits associated with IRAs were intended to encourage individuals to make adequate provisions for their retirement security. In fact, Congress' growing awareness that a large number of the nation's workers would face retirement with inadequate levels of savings led it to enact, as part of the 1981 Economic Recovery Tax Act, a significant expansion of IRA eligibility in order to promote greater retirement income security for all workers. Savings for the purpose of retirement also contribute to the formation of investment capital needed for economic growth.

The ABA supports the continued expansion of IRAs and believes their use should not only be encouraged but made available on a broad and consistent basis. We further support the proposed IRA changes as a step toward reducing the bias in our tax system against savings and investments. We would also encourage consideration of expanding the IRA further to the $2,500 limit as proposed in the original Treasury plan.

The Association is also concerned with the Administration proposal that, while not directly related to the industry's own tax liability, would affect us as employers and adversely impact the almost 2 million individuals we employ. I refer to the sweeping changes proposed to our current employee benefit laws.

Our industry has had a long history of providing for the health, welfare and retirement needs of its employees. With few exceptions, banks have not only assumed responsibility for making critical medical benefits available to their employees, they have also encouraged private savings and future retirement income security through the utilization of employer sponsored plans. These plans form an integral part of the American retirement system enabling workers to supplement their income during their retirement years.

The Association believes that our present private retirement system has served the nation very well. Congress has refined the system several times during the past several years resulting in a major restructuring of the laws governing employee benefit plans. Many of these new laws have yet to be understood and employers are still amending their plans and developing administrative procedures to meet the numerous new requirements. Moreover, the agencies charged with responsibility for administering these laws have failed to issue regulations dealing with the many complex issues created by the new laws.

The Administration's proposal will create more uncertainty in an already uncertain area of the law. We are concerned that the changes proposed to current employee benefit laws have not been adequately studied and their long term effect on the nation's employee benefit system has not been adequately considered. We, therefore, urge Congress to proceed very slowly in its deliberations on changing the employee benefit rules as part of an overall tax reform package.

The Administration's recent proposal to repeal the section 401(k), cash or deferred arrangements, deserves special comment. Banks, like many other employers, recognized the great value of this program for giving employees an opportunity to substantially increase their savings. Given the bias against savings in the tax code, both employers and employees have responded enthusiastically to this opportunity. Many banks now offer a 401(k) program. Banks have, of course, also been recipients of section 401(k) funds deposited by other employer plans. We believe it would be a serious mistake to close off this new source of savings. The low rate of savings in the United States is well known. Elimination of one of the few savings incentives can only make the savings rate worse.

While we support retention of 401(k) plans there is one aspect of the Administration's original proposal regarding section 401(k) that deserves mention. That proposal required individuals covered by a 401(k) plan to offset their IRA contributions against the contributions to the 401(k) plan. The Association believes this could threaten the continued growth of the IRA program and impose unwarranted restrictions on the freedom of investment choice available to IRA participants. As a result, many employees would be forced to choose between contributing to an IRA and foregoing the freedom of investment choice that sets IRAs apart from other retirement programs, or having a larger contribution made to their employer's 401(k) plan, with a limited choice of employer selected investment options.

The Association opposes the 401(k) IRA offset provision because we believe it would reduce IRA contributions and would impose a new set of complex rules and recordkeeping requirements on what is now a simple, easily understood retirement savings vehicle. In 1981, Congress created the universal IRA and eliminated any linkage between the availability of an IRA to an individual and his participation under an employer sponsored retirement program. Congress recognized that to ensure full utilization of this effective retirement savings vehicle, the IRA would have to be easily understood and established with a minimum amount of paperwork. Any imposed linkage between IRAs and 401(k) plans would convert this currently simple system into a complicated program fettered with burdensome recordkeeping and confusion.

Under current law, individuals are generally allowed a deduction for interest expense. However, interest on debt incurred to acquire or carry investment property is deductible only to the extent of the sum of $10,000 plus net investment income. Amounts disallowed under this limitation for any year may be carried over and treated as investment interest expense in the next taxable year.

The President's proposal would allow, in full, a deduction for interest expense incurred in a trade or business and interest expense incurred on a mortgage secured by a taxpayer's principal residence. All other interest expense would be deductible only to the extent of $5,000 plus net investment income. The limitation would be phased in beginning with interest expense incurred or paid after January 1, 1986. Interest currently subject to the investment interest expense limitation would still be allowed as a deduction up to $10,000 plus investment income (determined under new rules) prior to January 1, 1988. The limitation on the other interest expense would be phased in beginning with 10 percent in 1986 and increased by 10 percent in each subsequent year.

The limitation was proposed to prevent individuals with large amounts of tax shelter interest expense from using that expense to offset business and employment income. However, the provision may limit interest deductions on other personal loans such as second homes.

In addition, because the limitation applies to interest expense incurred on or paid after January 1, 1986, it penalizes those who made borrowing decisions on the basis that the interest expense would be deductible. Therefore, any cash flow projections made at the time the loan was made would no longer be valid. We question the wisdom of any limitation on interest deductibility.

The Treasury proposal provided that beginning January 1, 1989, a portion of interest income would be nontaxable and interest expense nondeductible. For banks and other lenders, the general effect of the interest indexing provisions would have been to exclude from taxable income the percentage of net interest which represents the annual inflation rate. Net borrowers would no longer have been entitled to a similar percentage of their interest deduction.

We viewed the interest indexing proposal as part of a series of indexing provisons intended to remove the effects of inflation from the income tax system. We are concerned that many other forms of investment remain indexed under the President's plan but interest indexing has been dropped. For example, a partial exclusion for capital gains is included in the President's proposal because ". . . the capital gains preference compensates for the fact that nominal gains, unadjusted for inflation, are included in income." After 1990, taxpayers can elect to use the exclusion or to index the basis of their capital assets. This difference in treatment may create a tax system bias against debt instruments in the future. We believe it is necessary to apply inflation adjustments to all forms of investment to prevent distortions in economic decision making. The unfairness of taxing the inflation premium inherent in interest income is self-evident. Nothing real was earned with respect to that segment, so nothing should be taxed. Taxing the inflation premium is particularly hard on groups such as the elderly and the poor who tend to make greater use of fixed interest debt instruments.

The borrower, of course, can benefit from the lack of an inflation adjustment by paying back a loan in cheaper dollars. The President's proposal, however, contains several provisions to limit that advantage. The interest deduction of individuals is limited to home mortgage interest and $5,000 of other interest expense, plus investment income. Corporations face a potential minimum tax on 25 percent of their net interest expense, limited by the extent of their accelerated depreciation.

We recognize that tremendous complexity is involved in attempting to adjust interest income and expense for inflation. We believe, however, that continued study of this issue is important if the equality of treatment of various forms of investment is to be achieved.

Mr. Chairman, this represents our views on the President's Tax Reform proposal. As I indicated above, the American Bankers Association does support the concept of tax reform. Tax reform, however, should recognize the traditional intermediary role played by banks in the tax system. This role has been and will continue to be important in ensuring that tax benefits, such as the tax exemption of state and local obligations, are available to all those for whom they were intended. Finally, Mr. Chairman, I hope that the broadening of the tax base is not used as an excuse to eliminate the reserve method of accounting for bad debts. The continued use of the reserve method is necessary to accurately compute a bank's taxable income.

Again, Mr. Chairman, we appreciate the opportunity to testify on this issue. We would be more than happy to supply any additional information needed or to answer any questions that you may have.

STATEMENT BY FINN M.W. CASPERSEN, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, BENEFICIAL CORP., PEAPACK, NJ

Mr. CASPERSEN. Thank you.

I am chairman of the board of Beneficial Corp. Beneficial is exclusively a provider of consumer financial services to American and foreign consumers. As such, we have a different viewpoint, perhaps, from many of my colleagues at this table. We do not lend to companies, we do not lend to countries; we lend almost exclusively, as I said, to the American consumer.

We favor this tax bill. We favor this tax bill not because of its effect on Beneficial—in fact, it will cost an incremental $100 million in tax payments over the next 5 years. We favor it because of the effect on the American consumer. That is our constituency; that is what makes us go.

We believe, based on our own studies, that this tax bill will result in increased economic activity, in increased disposable income, in increased prosperity for the American consumer.

We believe that this bill will end the perception—and I might add, an accurate perception—that the present tax system in the United States is unfair, that it depends not on how much money you earn, not on what income bracket you are, but instead on what type business you are and, on how able your tax counsel is.

We applaud several specific aspects of the bill. We applaud the continued availability of interest deduction on the primary residence. We think that is key to the American consumer. The American consumers' key methodology of saving is the primary residence, and they should be able to withdraw funds in the form of first, second, or whatever types of mortgages, on that house for so long as they own it.

We applaud the first step, small as it may be, toward dividend deductibility. We think this is very, very important. Too long has the American tax system been biased in favor of debt. There is a hidden cost of having a debt interest deductibility as opposed to not having a dividend deductibility, and that cost is being shown in the Continental situation in Ohio, in Pennsylvania, and in Maryland. We cannot have an overly leveraged financial system. We cannot have a tax system that encourages financial institutions to borrow to the hilt and to minimize equity investments. This dividend deductibility is a small step—a small step, 10 percent—toward that end, but it is very important philosophically, and it would have significant ramifications on the financial industry.

We particularly applaud the more-inclusive but lower rates for both corporations and for individuals. Before I joined Beneficial, I acted as a tax lawyer. Since I joined Beneficial, I have been in charge of strategies to reduce taxes and to maximize profits. I well know the incredible amounts of time, the incredible amounts of economic resources that are poured into lowering taxes payable, and I might add poured into unproductive activities, activities that are not core to the central nature of a corporation. The present tax law encourages that, and we all know that.

In conclusion I would suggest that we have a unique opportunity to rid ourselves of an unfair tax system. We have the opportunity that comes once or twice in a decade, and we should not lose it.

I would like just to close by challenging my colleagues both in the financial services and in other areas to think—not what is good for their particular company, not what is good for their particular industry, but to understand that what is good for the American consumer in the long run, and indeed usually in the short run, is good for American business.

Thank you, Mr. Chairman.

The Chairman. Thank you, sir.

Mr. Morris.

[Mr. Caspersen's written testimony follows:]

STATEMENT OF

FINN M. W. CASPERSEN

Mr. Chairman and members of the Committee, my name is Finn Caspersen. I am Chairman of the Board and Chief Executive Officer of Beneficial Corporation. I appreciate your invitation to appear before this Committee to express Beneficial Corporation's strong support for your efforts to reform our tax system.

Tax reform, in the form proposed by the President, will increase Beneficial's taxes by $100 million over the next five years. Nevertheless, we support the President's proposals, for one very simple reason--we believe they will benefit our customers, and thus in the long run, both the economy and ourselves.

Two months ago, I made statements similar to these before the Committee on Ways and Means of the House of Representatives. In the ensuing weeks, I have been gratified to see this theme recognized and endorsed by national newspapers, by major corporations and by average, middle-class Americans.

The lead editorial in the September 12th issue of The Wall Street Journal notes that this type of thinking may be spreading; such major corporations as General Motors, General Mills and IBM are now taking similar stands.

Here we have a situation in which corporate America and middle-class America can--and do--agree. As corporations and as individuals, we are perfectly willing to pay our fair share of the tax burden. But we insist on a level playing field. We want a tax system that is FAIR to all. There are many aspects to the President's tax proposals; fairness is the one we endorse above all others.

To place my views in context, Beneficial is a leading lender in this country. But Beneficial, unlike many other financial institutions, is first and foremost a consumer lender. We do not lend to governments or in any significant amounts to large businesses. Our primary mission is to supply credit to the public at a fair and profitable rate. We provide this credit in many forms--through our 1,135 loan offices in 40 states, Canada and the United Kingdom; through the issuance of Visa and MasterCard cards; and through retailers of all kinds throughout the country. We lend both on an unsecured and secured basis. We are the largest second-mortgage lender in the country. At the end of June, we had $5.5 billion of loans outstanding to more than 2.3 million customers. Most of our customers are the American middle class; with household incomes that typically range from $20,000 to $50,000. Beneficial Corporation's stock is traded on the New York Stock Exchange and is owned by more than 26,000 shareholders.

When we say that tax reform will benefit our customers, it is for this reason: most of our customers will pay less taxes and, therefore, have more disposable income to save, spend or invest. This, obviously, will benefit us directly. As Americans become financially healthier, they will be better customers for our services. As Secretary Baker pointed out in his testimony, most taxpayers will pay less taxes and most of our customers, namely those families with between $20,000 and $50,000 of household incomes, will pay 7.2% less taxes.

This will obviously improve these families' well-being. These people are not motivated by tax avoidance. They are motivated by the most basic of purposes: to own a home, to educate their children, to protect their health, to prepare for retirement. Tax reform will help them to achieve their piece of the American dream.

Higher after-tax family incomes will also benefit the general economy. Many economists believe the economic recovery in recent years was led by the willingness of the consumer to spend and invest. If the tax changes result in more disposable income as predicted by Secretary Baker and others then the scenario could be repeated.

Beneficial supports tax reform even though its corporate income tax payments will increase in the aggregate by $100 million over the next five years, the period being used to measure the revenue impact of the proposal. The reason for this increase in tax payments is twofold: first, the transition rules in the President's proposals moderate the benefit of the rate reduction during the first five years of the changes; and second, Beneficial like many other companies structured its financial affairs and made investments over the past several years with the specific purpose of minimizing its corporate income tax burden. It would probably no longer be prudent or economically viable to make such investments if the tax reform proposals are adopted in their present form.

I would now like to turn to the specific provisions of the President's tax reform proposals upon which we base our support for both our customers and the company. Looking first at our customers, the key words in the Treasury proposal as it applies to individual taxpayers are "fairness and simplicity." The tax system today has become extremely complex and riddled with provisions for special interest groups; it is perceived by the average American taxpayer to be unfair. In order for the voluntary nature of our income tax system to survive, it is important that this perception be changed. We believe that fairness will be achieved by adopting the President's proposals that broaden the tax base, lower tax rates, and eliminate special deductions, special tax credits and other preferences.

Simplicity and fairness are inter-related. A tax system that is complicated is perceived as unfair because its interpretation is restricted to those who can afford to employ tax experts. We do not expect Congress to adopt, in total, the President's proposals for tax reform. However, we believe it's important that, when the dust settles, the average American must feel that he is better off as a result of these changes and, specifically, that his tax burden has been reduced. If this objective is accomplished, and only if this objective is accomplished, will tax reform achieve its stated goals of fairness and simplicity.

The President's tax reform proposals address two specific deductions that are very important to our customers. They are the home mortgage interest deduction and deductibility of consumer interest. We applaud the Administration for stating as one of the tax reform goals "the home mortgage interest deduction should not be jeopardized." This was enumerated by the President in his State of the Union Address and once again by Secretary Baker before this committee. The President's tax reform proposals permit taxpayers to deduct all of the interest on loans secured on their primary residence. This is of paramount importance to our customers if they are to enjoy the benefits of the American dream of home ownership.

Some have advocated that the home mortgage interest deduction should be limited to the mortgage incurred at the time the house was purchased. We strongly disagree. Implicit in the American dream of home ownership is to one day recognize the increased value in the equity in one's home. Refinancings and second mortgages help middle-class Americans unlock that equity without having to sell their family homes. They are able to finance college educations, pay medical bills, make home improvements or, generally, just improve the quality of their lives. Furthermore, to try to condition the deductibility of interest on the basis of the form of the loan or the use of the proceeds would be inconsistent with tax simplification and would be difficult to enforce and administer.

The President's tax reform proposal further provides that interest expense other than that associated with indebtedness on a principal residence will be deductible up to $5,000 plus investment income. We agree with Secretary Baker that the majority of families will never be affected by the latter limitation; it would serve primarily to curtail the economics of the tax shelters that higher income taxpayers currently utilize to reduce their tax liabilities. We would recommend, however, that the $5,000 limitation be indexed for inflation so that legislative changes will not be necessary in the future if inflation causes interest rates to rise to the very high levels of just a few years ago.

Turning to the reform of corporate taxation, we are pleased to join General Motors, IBM, J.C. Penney and many other distinguished companies who have appeared before this committee to support corporate tax reform around two common principles: the reduction in the corporate income tax rate from 46% to 33% and the introduction of the deduction for dividends paid. Like Beneficial Corporation many of these companies will incur increases in their tax burden under the President's proposals. Like Beneficial, they have decided to support this type of tax reform despite the increased cost. They understand that the benefit to their customer and the fundamental fairness which follows from eliminating special preferences and creating a "level playing field" will insure that decisions are based on market motivation not tax considerations. Overall, the reduced rate will encourage economic growth that will lead to better long-term profits for their corporations.

I encourage this committee to look very closely and put a high burden of proof on those companies and those trade associations that argue for the maintenance of special provisions which tilt the playing field in their favor.

Beneficial pays relatively high dividends to its shareholders. We are thus concerned with the partial deduction for dividends paid in the President's proposal. The current system taxes corporate earnings twice. Once when they are earned by the corporation and again when they are received in the form of dividends to its shareholders. While we favor a deduction higher than 10% for dividends paid, we applaud the introduction of the concept and would agree that it should be tempered with the overall need for revenue neutrality.

American businesses are already too highly leveraged because of the deductibility of interest and the non-deductibility of dividends. For the sake of the stability of our financial system, we must encourage more equity investment and less leverage. The partial deductibility of dividends is an essential first step towards this end.

In conclusion, I recommend and challenge other financial institutions not to limit their support or reaction to the impact of the President's proposals on their special tax preferences in the Internal Revenue Code. Instead, they should take a broader look at the significance of the reform proposals to the overall economy and especially at its impact on their customers. Ultimately, it will be the health and success of their customers that will control their future profitability. Let's not let the tax system continue to dictate economic decision making. Let the market and consumers provide such initiative.

The tax system should be fair. It should collect enough revenue to support our country and its citizens but not favor one industry over another or one form of capital allocation over another. I agree with many that have come before this committee that the tax laws are now a form of industrial policy. This should be eliminated to the greatest extent possible, in order to introduce a perception of fairness and neutrality in the revenue system.

The job of this committee and Congress is a very difficult one. There should be no doubt that with such sweeping tax reform changes there are risks. The answers will not be known nor can the economic result be known with any high degree of certainty. However, the time has come for tax reform legislation to be enacted that is founded on fairness and simplification not special interests. The time for tax reform is now. I learned from listening to our customers that a consensus of the American people want tax reform. We, at Beneficial, are prepared to help you in this historic undertaking for fundamental tax reform. Thank you.

STATEMENT BY JOE MORRIS, PRESIDENT, COLUMBIA SAVINGS ASSOCIATION, EMPORIA, KS, AND VICE CHAIRMAN-ELECT, U.S. LEAGUE OF SAVINGS INSTITUTIONS

Mr. MORRIS. Thank you, Mr. Chairman.

I am Joe Morris. I am president of Columbia Savings of Emporia, KS. I appear this morning on behalf of the U.S. League, its 3,500 savings and loan and savings bank members nationwide.

The league appreciates this opportunity to discuss the administration's tax proposals and their application to our specialized thrift and home-finance industry.

We urge this committee and the Congress to proceed with caution, to avoid unseen damage to our industry, which as you know remains in a fragile condition, and to avoid unseen damage to our Nation's economic structure.

The administration's request would eliminate the section 593 bad-debt reserve deduction and tax our institutions at the 33-percent rate proposed for corporations generally. For the future, our bad debts would be handled through specific chargeoffs. Specific chargeoff is not appropriate for financial intermediaries which invest primarily in long-term real estate mortgages, since it would postpone tax recognition of loan-loss expense until after the expense has been incurred economically.

Reserve accounting more accurately measures economic income, particularly for financial institutions.

As a corollary, the administration also proposes to recapture into taxable income a portion of past bad-debt reserve accumulations. Though Treasury is vague on the precise calculation of the recapture, they agree that this new liability for thrifts could approximate $2 billion. While the cash tax collection would be spread over 10 years, financial statement accounting impact would be immediate and severe. Our institutions would be required by their accountants to establish a deferred tax liability. This unique and unfair recapture would wipe out at one stroke a substantial portion of our industry's net worth, doing severe damage to our recovery. It would increase the exposure of the FSLIC and the FDIC, and reduce the availability of housing credits that we provide.

In my own institution, a study by Arthur Young showed that the effect of the bad debt recapture alone would increase our effective tax rate for each of the next 10 years from 31 percent to 39 percent.

The U.S. League therefore recommends retaining a scaled-back reserve method of 5 percent of taxable income, which more closely approximates thrift loss experience. This 5 percent is down from 40 percent under current law. Preserving the reserve method, even at a much lower level, will continue the incentive for investment in housing while removing the threat of recapture.

The administration also proposes the same 3-year carryback/15 year carryforward net operating loss treatment for financial institutions which now applies to corporations generally, rather than the 10 back/ 5 forward pattern we presently utilize.

Furthermore, only losses after January 1, 1986, would be eligible for the extended carryforward period.

While we support parity in the 18-year total carryback/carry forward period, we would recommend a different combination. A 10-year carryback should be retained for thrift institutions in recognition of the special safety and soundness concerns unique to our depositories.

Net operating loss carryforward should be extended to 8 years, and existing net operating losses should be eligible for any carryforward extension.

My full written statement explains our opposition to the administration's mandated switch to accrual rather than cash-basis accounting for financial intermediaries, and the particular inequity of the excess-depreciation recapture proposal in the case of savings institutions.

As a final point, the proposed repeal of the deduction for State and local taxation creates a special problem in our cost-of-funds competition with the U.S. Treasury issues. This will further complicate the problems of mortgage affordability in addition to the well-recognized pressures on housing affordability and values from the denial of the property tax deduction.

We have appreciated this opportunity to present our views on how our business would be affected, and we look forward to your questions and look forward to working with you.

The Chairman. Thank you.

Mr. Morris. Thank you very much, Mr. Chairman.

The Chairman. Mr. Cannon.

[Mr. Morris' written testimony follows:]

STATEMENT OF JOE C. MORRIS, PRESIDENT, COLUMBIA SAVINGS ASSOCIATION, F.A. EMPORIA, KS, IN BEHALF OF THE U.S. LEAGUE OF SAVINGS INSTITUTIONS

Thank you, Mr. Chairman, and members of this distinguished committee. My name is Joe C. Morris and I am President and Chief Executive Officer of Columbia Savings Association, F.A. of Emporia, Kansas. I appreciate this opportunity to appear before you today in my capacity as Chairman of the Committee on Corporate Taxation of the U.S. League of Savings Institutions.[1]

The U.S. League strongly supports the overall objectives of fairness, simplicity and growth advocated by President Reagan in his tax reform proposal. Few sectors of the economy have as much to gain from well-crafted reform efforts as savings institutions. As promoters of thrift and home ownership, we offer the straightforward type of loan and savings products which should be encouraged by the reform process. As a result, we are somewhat dismayed by adverse and unnecessary provisions in the Treasury package which would reduce our institutions' ability to serve our customers. We hope that, in working with your distinguished committee, as well as with House Ways & Means, we shall be able to revise these provisions into a more constructive form.

Certainly, every American shares the goals of encouraging capital formation, entrepreneurial activity, and job creation. Many of the provisions of the current tax system, though initially well intended, may no longer be serving those original purposes and should be reviewed. The Treasury study has been of real benefit in producing a comprehensive study of the special provisions incorporated over the years in the basic tax code.

---

[1] The U.S. League of Savings Institutions serves the more than 3,500 member institutions which make up the $1.1 trillion savings association and savings bank businesses. League membership includes all types of institutions—federal- and state-chartered, stock and mutual. The principal officers include: John B. Zellars, Chairman, Atlanta, Georgia; Gerald J. Levy, Vice Chairman, Milwaukee, Wisconsin; William B. O'Connell, President, Chicago, Illinois; Philip Gasteyer, Executive Vice President and Director of Washington Operations; and James O. Freeman, Senior Legislative Representative. League headquarters are at 111 East Wacker Drive, Chicago, Illinois 60601. The Washington office is located at 1709 New York Avenue, N.W., Washington, D.C. 20006. Telephone: (202) 637-8900.

Over 30 years worth of amendments have been added to the 1954 Internal Revenue Code. Each change has certainly produced new tax complexity without necessarily contributing to tax fairness.

Despite the good intentions of the framers of every special provision, there can be little doubt that the sheer complexity of the code and the growing public perception of its unfairness and arbitrariness have begun to threaten the essential broad-based support, voluntary compliance and self-assessment on which the system is based. Such a trend presents a real threat to the well being, fiscal integrity and even national security of our country. Such a threat clearly merits congressional response.

But another threat to those shared values looms even larger. That is the danger from uncontrolled federal budget deficits. Tax reform is an issue of critical importance, but it is vital that the reform effort should not supplant deficit reduction efforts.

The League applauds the initial steps taken by the Congress in forming the 1986 budget targets, but clearly much remains to be done. We recommend that the Congress examine proposals to reform the tax code from the constant perspective of tailoring that effort to mesh with the deficit reduction drive.

The need for the incentive to economic growth from reductions in marginal income tax rates must also be balanced with the retention of critical tax deductions embedded in both the tax code and the economic life of the nation. The Administration proposal is a logical starting point for tax reform, but we strongly suggest that insufficient attention has been paid therein to the sectoral impacts of the proposals.

As the major supplier of home mortgage credit to the nation, we are particularly concerned by the potential for severe impact on housing activity. The macroeconomic impact of the Administration's plan is also of vital concern to the thrift industry. It is by no means clear that the indirect benefits the package would bring in lower interest rates (from the projected increased savings flows at lower individual tax rates) will be enough to offset the direct burdens on homeownership costs. In addition, the adverse impacts of certain provisions of the reform proposals would severely limit the ability of our specialized institutions to continue to provide mortgage finance, and thus further increase the costs of homeownership.

Measuring the particular economic impact of the tax code changes is difficult even for individual items, but for such a broad range of simultaneous tax code revisions the difficulty is greatly compounded and resulting economic projections are less reliable. Our savings institutions have recently survived a prolonged period of high interest rates, deregulation of liabilities before assets, and increased competition for savings, which forced over 900 of our members to be merged. acquired, or liquidated. Savings institutions cannot soon tolerate another bout of high interest rates. Our eroded net worth could not support the certain losses that would result.

We, therefore, urge the Congress to proceed with caution, examining where possible both the macroeconomic and sectoral impact of the President's plan in order to avoid potentially harmful and unforeseen damage to our underlying economic structure.

The President's recommendations would totally restructure the tax treatment of savings institutions as corporate taxpayers. The core provision of savings institution taxation under present law is a special provision allowing a percentage of taxable income to be set aside as a bad debt reserve: almost all other unique aspects of savings institutions tax flow from this one item. The repeal of this Section 593 special deduction would thus essentially eliminate the distinctive tax treatment accorded savings institutions by Congress for the last 23 years.

A brief look back into the history of financial institution taxation shows that as long ago as 1921 commercial banks were provided a reserve deduction for debts which become worthless during the year in addition to an allowance for future bad debt exposure. Savings institutions by contrast, remained exempt from federal taxation until 1951 when tax liability was imposed on income exceeding 12 percent of an institution's savings balances. Then in the Revenue Act of 1962, savings institutions, like commercial banks, became subject to regular federal corporate tax except for the option of the special thrift percentage-of-taxable-income bad debt deduction (Sec. 593(b)(2)). Congress, in granting this deduction, recognized the substantial risks involved with long-term lending and the importance of credit to finance homeownership.

This benefit was also to encourage savings institutions to remain specialized housing originators and investors. Thrifts received the maximum tax benefits of Section 593 when 90% (pre-1969) of their assets were in certain housing credit-related and necessary liquidity "qualifying assets." Today (post-1969), 82% of savings and loan and stockholder-owned savings bank investments must be in cash, government and municipal obligations, real property loans, or other housing-related investments in order to receive maximum benefit from the bad debt percentage-of-income deduction. (Mutual savings banks receive maximum use of the percentage-of-taxable-income method when 72% of their investments are enumerated qualifying assets.) These housing-investment orientations are the "price" thrifts must continue to pay to enjoy the maximum tax benefits of Section 593. The special thrift bad debt deduction is denied to all thrifts, mutual and stock, savings and loan association or savings bank, if less than 60% are in qualifying assets.

As indicated, Congress in 1969 granted full use of the special thrift bad debt deduction to savings banks with a 72% qualifying assets ratio—in recognition of historical differences between savings and loan associations and mutual savings banks. In the intervening years, the two types of institutions have become virtually indistinguishable, particularly with the passage of the Garn-St Germain Depository Institutions Act of 1982, which encouraged new investment flexibility to assure continued institutional viability. In the event that tax legislation in this Congress does not take the radical step of abolishing the special thrift tax treatment, we would recommend that all savings institutions be allowed full use of the bad debt deduction at the 72% level. The key role of thrifts in home finance can be expected to continue on the grounds of management expertise alone, absent any radical downgrading of homeownership benefits in the individual income tax structure. The asset composition test at 72% will assure the long-term commitment to home finance by all thrift institutions in the modern economic environment.

The record of savings institution commitment to housing is well established. Today the $1 trillion savings and loan business and the $300 million savings bank industry hold more than 50% of private residential mortgage debt and 40% of all mortgages nationwide. Thrifts have fulfilled congressional intent by serving as the primary source of credit for home buyers and sellers well beyond the expectations which prompted the changes made in the Revenue Act of 1962. Their housing specialization—mandated, in part, through our federal tax code, has not, however, come without cost. Thrifts continue to face the peculiar risks of long-term home financing specialists—incurring, in particular, significant operational losses from the inherited mismatch of short-term deposit costs and long-term investment returns during the recent high interest-rate period.

The Ways and Means Committee report accompanying the Revenue Act of 1962 clearly indicates that the special bad debt reserve approach was to provide "reserves consistent with the proper protection of the institution and its depositors in light of the peculiar risks of long-term lending on residential real estate." Congressman Keogh referred to the peculiar risks associated with long-term real estate lending in a March 28, 1962 floor speech advocating the new percentage-of-taxable-income reserve method. Keogh stated that a thrift institution:

". . . is a different kind of organization from a commercial bank . . . the matter of investment losses is quite different between the two types of organizations. Home mortgage investments are long-term investments with different risk characteristics than short-term commercial paper. It was clear to the Committee on Ways and Means that loss reserve provisions applicable to loss experience on commercial paper have no relevance to an appropriate reserve on long-term real estate loans.

Actually there is no certain formula that will tell us what is the exactly appropriate loss reserve for long-term real estate loans. The very uncertainty of these losses is the problem."

Congress was extremely prescient in making provision for unforeseeable, extraordinary losses in the mandated home financing specialization. It is true that the losses ultimately arose from the interest rate risk built into the mortgage portfolio rather than default risk, but the reserve accumulation permitted under the tax code was vital in weathering the storms of the last few years.

We emphasize that these tax favored reserves are not available for distribution to stockholders, but must be retained to cover the losses against which they were provided. Indeed, without the percentage reserve method granted our institutions in 1962 and the additional $5 billion in reserves attributable to that provision, the thrift business would have been hurt even more by the devastating losses of 1981 and 1982.

The 1969 Tax Act was the last major revision of financial institution taxation. In the 1969 Act the allowable thrift percentage bad debt allocation was reduced over 10 years from 60% and 40% of taxable income. At the same time this phase-down of the bad debt reserve deduction was enacted, Congress attempted to reduce any negative impact of this change by granting financial institutions special net operating loss (NOL) treatment of 10 years carryback and 5 years carryforward in order to "provide an extra margin of safety to protect against the possibility of unusually large bad debt losses." (Report of the House Committee on Ways and Means to accompany H.R. 13270, the Tax Reform Act of 1969).

Since 1969 additional tax changes have been enacted which have altered the tax status of thrifts. The 1981 Economic Recovery and Tax Act provided greater net operating loss carryforward treatment (15 years) for ordinary corporations. Despite this significant enhancement of the regular corporate carryover period, financial institutions were held to their pre-1981 5-year carryforward level. The 1981 Act also required stock-form savings banks to maintain the higher savings and loan level of qualified investment (82%) in order to receive the maximum bad debt percentage deduction. In 1982 the Tax Equity and Fiscal Responsibility Act, and then in 1984 the Deficit Reduction Act combined to cut back by 20 percent the amount by which the bad debt reserve deduction (Sec. 593) exceeds the amount which would have been allowable on the basis of actual experience. This new corporate tax preference Section (Sec. 291) of the code—which disallows a portion of preference items—has somewhat undermined the traditional tax treatment originally accorded thrift institutions by Congress in 1962.

The U.S. League believes that all corporations enjoying the fruits of our economic system have a continuing obligation to contribute adequate tax revenues to meet the expenditure needs of the nation. The thrift business is one industry which continues to meet its tax-paying responsibility in this regard.

In spite of the benefit of Section 593, thrifts have been paying an increasing amount of federal income tax beginning with the Revenue Act of 1962. As outlined above, this level was increased by the Tax Reform Act of 1969. The following Table I depicts the higher statutory thrift tax rate from the 1969 bad debt reduction, as well as the increased tax liability resulting from the bad debt cutbacks in the 1982 and 1984 Tax Acts.

Thrifts have essentially paid taxes at this statutory rate. Unlike money-center commercial banks which have used a variety of tax management techniques to reduce the U.S. tax liability on worldwide and U.S.-derived income to extremely low values, profitable thrifts face effective federal tax rates of approximately 30%. Table 2 depicts the actual federal taxes paid by thrifts over the 1970s. (The table stops at 1979 since beginning in 1980 many institutions sustained losses, and virtually the entire industry became unprofitable in 1981 and 1982: thus the percentage-of-taxable income method has been little utilized by thrifts in this decade.) In tax year 1985, however, the business will show the best earnings performance since the late 1970s and will return to significantly positive tax-paying status. Clearly, thrifts will continue to contribute their fair share of federal corporate revenues as they return to health.

TABLE I

[In percent]

Taxable year beginning	BDD-percentage of taxable income method	Statutory tax rate
1969	60	19.2
1970	57	24.28
1971	54	25.27
1972	51	26.27
1973	49	26.93
1974	47	27.60
1975	45	28.26
1976	43	28.92
1977	42	29.26
1978	41	30.22
1979	40	29.46
1980	40	29.46
1981	40	29.46
1982	40	29.46
1983	34	30.36

TABLE 1—Continued

[In percent]

Taxable year beginning	BDD-percentage of taxable income method	Statutory tax rate
1984	34	30.36
1985	32	31.28

TABLE 2

[In millions of dollars]

Taxable year	Pre-tax book income	After-tax book income	Book Federal tax expense	Federal taxes paid
1970	$1,165	$925	$216	$186
1971	1,748	1,313	359	314
1972	2,317	1,687	517	457
1973	2,655	1,897	621	541
1974	2,143	1,482	532	468
1975	2,082	1,448	500	406
1976	3,218	2,249	775	628
1977	4,610	3,198	1,151	1,018
1978	5,716	3,918	1,435	1,275
1979	5,197	3,619	1,307	1,091

Source: U.S. League of Savings Institutions, Federal Home Loan Bank Board data cross-checked with Corporation Income Tax Returns (Treasury Department) for the various years.

Note that the combination of financial and tax return data produces a different value for the effective tax rate, the proportion of income taken by taxes, than the computation from the taxable income base. No single measure of tax burden is completely satisfactory. This method gives the lowest figure for the corporate tax bite.

The Administration's current proposal to eliminate Section 593 would reverse 23 years of tax and housing policy. At first glance, that may not be of too much concern. Today savings institutions, because of their portfolio specialization, do not utilize tax incentives enjoyed by other depository institutions and consequently the 33% rate proposed by the Administration closely approximates current thrift marginal tax rates.

The Treasury tax reform plan, however, goes much further than abolishing the special thrift bad debt reserve method. The plan would abolish entirely the reserve method of providing for bad debts by all taxpayers. Instead, a system of specific charge-off would replace the traditional and well-understood reserve methodologies. (Today most corporations may utilize a six-year moving average of bad debt experience, a method also available to thrifts and commercial banks; commercial banks have a second option of the use of a percentage-of-eligible-loans bad debt addition; thrifts may use any of the moving average experience, the commercial bank eligible-loan or the thrift percentage-of-income methods).

The Treasury argues that any reserve method of accounting for bad debts overstates the true size of bad debt losses and that the charge-off system, delaying any deduction for such bad debts until actual write-off, is preferable theoretically and more accurate practically. We do not accept such a contention. Though there may be some legitimate debate over "excessive" deductions from certain hitherto permissible bad debt methodologies, such debate is a separate issue from the question of the validity of reserve accounting. In fact, such reserve accounting is clearly better matched on theoretical grounds to the accrual basis of accounting which the Treasury advocates elsewhere in its reform package and which we shall address later in this statement.

The U.S. League strongly urges the retention of some method of reserve accounting for bad debts, at least for financial intermediary bad debt exposure. For most corporations not engaged in the business of lending funds, except perhaps in the form of trade credit, bad debt losses are probably a minor and incidental expense. For financial intermediaries, bad debt reserves are an integral part of their basic business and deserve more analysis than offered in the Treasury package.

Specific charge-off as a substitute for reserve accounting is totally unsatisfactory especially for mortgage loans. The method fails to take into account the timing of the lender's economic loss from bad debts. These economic losses occur much earlier than the point at which a loan can be formally written off for tax purposes. The write-off for a bad loan is usually the last step in a drawn-out process which starts when a loan becomes troubled, continues through a work-out or foreclosure period, and culminates only when a loan is either finally collected or written off.

Specific charge-off postpones the tax recognition of any loan loss expense until after this expense has been incurred economically, whereas reserve accounting more accurately measures economic income.

In addition to the theoretical shortcomings of the proosal to eliminate the reserve method of accounting for bad debts, this flawed element of the Administration package brings with it a host of ancillary complications. The proposal is intimately linked to the requirement to "recapture" the tax benefits from past bad debt deductions.

Henceforth, when assets go bad, the loss will be charged directly to taxable income rather than to a tax reserve dating back to the original investment period. (If accumulated bad debt reserves are not recaptured, taxpayers would, in effect, get a double deduction—once, at the time of the initial addition to the reserve, and, second, in the future when the loss is directly charged on the tax return rather than to the reserve.) Consequently, under the Administration's plan, accumulated bad debt reserves are recaptured so that every taxpayer's returns will retroactively be revised "as if" this new system had always been in effect.

Retroactive legislation is seldom advisable. When a "go forward" proposal mandates such a complex retroactive adjustment, warning signals are being sent. This entire section of the package requires rethinking.

For savings institutions, the impact of the recapture proposal is peculiarly adverse. The burden of actually having to pay the tax may be the lesser of the associated problems for savings institutions. The special bad debt reserves accorded thrifts since 1962 were in return for their concentration on residential finance. That concentration, in an era of deposit rate deregulation, combined with historically high interest rates, proved exceptionally costly to many institutions. The Administration partially recognizes that connection and has not proposed a recapture of all the benefits of the special thrift bad debt deduction but only of that part equivalent to what could have been claimed had the thrift bad debt method never been enacted.

The portion to be recaptured would be the greater of the commercial bank method (Section 585) and the actual loss experience. (Treasury officials have yet to declare the precise calculation of the equivalent "commercial bank reserve" to be recaptured.) Furthermore, under the Treasury's plan, this amount could be taken into income by the thrift either in the first year or over 10 years. Though this partial recapture approach appears to be "fair", it hardly leaves an institution in the flexible investment portfolio position of a commercial bank. Not only would the President's plan eliminate all special tax incentives for thrifts to continue to focus their investment in housing, but even in its revised Administration form, recapture would still retroactively penalize institutions.

We estimate that the associated tax liability over ten years could be as much as $2 billion for our institutions. However, the financial statement impact would not be deferred over that period.

In its consideration of how to reflect the tax savings for an institution from the use of the thrift bad debt reserve method, the accounting profession accorded that benefit the statues of a permanent difference between book and tax return income. The provision enacted in 1962 and adjusted in 1969 was not scheduled for phase-out, as was the case for the commercial bank method and no mention of recapture was ever made.

Consequently, the thrift tax savings flowed through the income statement into the net worth accounts of the business, quite unlike the situation at commercial banks, where the tax saving was transferred to a deferred tax liability account. Commercial banks will face the cash flow burden of actually paying the recapture tax. Savings institutions will first have to reflect a new tax liability on their books far in advance of the actual payment of the tax.

At the moment and by coincidence, the entire financial accounting methodology of reflecting the impact of changing tax laws and rates on the financial statements is in flux. Because of the uncertainties in the relative timing of the tax law and accounting principles revisions, no definitive answer on the magnitude of financial statement impact can be given. However, it appears in all likelihood that savings institutions will encounter a uniquely severe impact from the recapture of bad debt reserves as recommended by the Administration.

The Financial Accounting Standards Board (FASB) is expected to require immediate creation of a deferred tax liability on thrift financial statements. So while the tax impact can be spread over 10 years, the financial statement impact from recapture could be immediate, wiping out at one stroke a substantial portion of existing thrift institution net worth nationwide.

Following the massive erosion of net worth in our industry 1981 and 1982 and the slow return to profitability thereafter, this check to thrift sector recapitalization by reserve recapture will be sorely felt by both the housing sector and the federal agencies responsible for insuring depositors against institutional failure.

Even the need for revenue neutrality with the President's Tax Proposal does not justify such an inequitable result. In any event the adverse impact on fragile thrift financial statements far outweighs the minimal revenue pick-up.

We are aware that tax writing Committee staff are cognizant of the problem and have discussed a number of alternatives to the Administration recapture proposal, but will within the overall framework of the specific charge-off methodology as the sole prospective bad debt deducation method.

It may be possible to structure a system whereby the major immediate financial statement reduction in net worth is avoided. If so, the Treasury may still actually benefit to the tune of the approximately $200 million per year forecast from the recapture. Each dollar of net worth can be leveraged by approximately $30 of new assets and liabilities.

The $2 billion net lost by bad debt recapture could thus support $60 billion of balance sheet expansion. At a modest 1% profit margin on that expansion an additional $600 million in taxable earnings would be booked, giving the $200 million in taxes that would have been raised by recapture itself, but have produced by continued thrift institution capacity to serve the mortgage market.

Though these alternatives are indeed more attractive than the Administration proposal, we remain unconvinced by the entire underlying philosophy.

The entire question of reserve method accounting for thrifts should be carefully studied by Congress. The existing system was enacted in recognition for the portfolio restrictions characteristic of both federal and state-chartered thrift institutions in 1969. Clearly, some significant (though modest) liberalization of asset authorities has been achieved at both federal and state levels in the intervening quarter-century—but that liberalization has been accompanied, indeed preceded, by total deregulation of savings deposit interest rates. So far, the outcome of the deregulation process has been to weaken, rather than strengthen, institutions—though, at this point, the future looks far more promising.

Even so, it would be appropriate for this Congress to take cognizance, as did its predecessor, the 87th Congress, of the continuing portfolio restrictions on savings institutions. While the Administration's tax proposals in advocating a unform tax treatment for depositors implicitly assume that absolutely complete investment freedom has already been granted to thrift institutions or will be shortly, the Banking Committees in each House of Congress have legislation under review which would maintain a number of significant constraints on investments by federally-chartered thrifts and, for the first time, impose federal limits on the exercise of state-charter empowerments. (On June 12, the House Committee on Banking, Finance and Urban Affairs reported H.R. 20 which substantially revises the "qualifying assets" test and applies it to new purposes: similarly, the Senate Banking Committee has under active review companion legislation.)

Though the outcome of that legislative process cannot be predicted with certainty and since some restriction on unfettered use of state powers is warranted to protect the Federal Savings and Loan Insurance Corporation, it would be appropriate for this committee to reconsider whether or not to retain some special tax incentive for home finance specialization.

The 33% regular corporate rate proposed by the Administration comes relatively close to the current 31.3% rate applicable to thrifts making full use of Section 593. This close correspondence makes it possible for our institutions to contemplate the loss of the special bad debt deduction, but the need to retain some tax incentive to compensate for the opportunity cost of continuing portfolio restrictions still remains.

In addition, the problems from the elimination of the rserve method of accounting and from bad debt recapture cry out for solution. One approach which could address all of these problems simultaneously would be to revise the special thrift bad debt deduction from its current effective level of 32% (the statutory 40% level reduced by the 20% preferrence scaleback under the 1982 and 1984 tax acts) down to 5% to 10%. Such a value would reduce the statutory thrift rate to esentially the 31.3% present level, assuming a new general corporate rate of 33% and would, at historical profitability levels, approximate actual bad debt experience losses. (At a pretax item on assets of 0.90%, a 5% to 10% special thrift bad debt reserve would give an addition of approximately 0.05% to 0.10% of loans addition to the bad debt reserve.)

Such a reserve method retention would eliminate the need for retroactive recapture linked to specific charge-off, would narrow the gap between experience-level losses and thrift bad debt deductions, and would provide a mechanism whereby the fragile thrift sector could be insulated from any subsequent movement from the suggested regular corporate tax rate level of 33%.

Any increase in the recommended, basic 33% corporate rate without special provision for our institutions—for example by the retention of a special bad debt deduction—will seriously jeopardize our business and its ability to fulfill its role as the nation's primary source of home mortgage credit.

As a related point, should the Congress decide to phase down the regular corporate rate from 46% to 33% rather than make the switch immediately, the Section 593 benefit will also have to be phased down proportionately to avoid an unintended adverse impact on thrifts.

For this and the previously mentioned reasons, the U.S. League opposes the imposition of the charge-off method and recommends forgiving accumulated build-up of past bad debt reserves and making a fresh start with a reserve method which more closely approximates actual loss experience. A number of technical issues arise in this area relating to the restrictions on any grandfathered reserves (and thus will arise even under the Treasury plan). These questions revolve around Section 593(e) and we would be happy to discuss them with Committee staff. Despite these technical complexities our overall position is very simple: If recapture is not eliminated, the U.S. League cannot support the President's tax reform proposal.

Financial institutions have operated since 1969 using a net operating loss treatment of 10 years carryback and 5 years carryforward. At the time, this was a more generous departure from the general corporate rule of 3 years carryback and 5 years carryforward.

Subsequent changes in tax law and regulation have reversed that favored position for savings institutions. In 1979, the Treasury, without any legislative prompting, adopted a new regulation whereby the tax refund benefit of an NOL carryback was halved. Under that regulation, institutions were required to reduce the allowable special thrift bad debt deduction by an amount proportional to the amount of the NOL carried back to that previous positive tax payment year. The effect is to increase the tax liability of the institution and reduce the refund. This change was made, by coincidence, exactly at the time when widespread operating losses begin to threaten the business. Its impact on tax recoveries has been severe. Citing the need to "provide an extra margin of safety to protect against the possiblity of unusally large bad debt losses." Congress had provided the benefit of longer carryback for net operating losses to offset reductions to the thrift bad debt reserve contained in the same 1969 Tax Act.

Shortly after this IRS regulation, in 1981 the Economic Recovery and Tax Act (ERTA) left the NOL rules for financial institutions unchanged at a time when nonfinancial corporations were granted a more favorable 15-year carryforward authority. This new rule, plus the existing 3-year carryback, provided nonfinancial corporations with a greater 18-year net operating loss aggregate carryover period than the combined 15-year treatment (10 back, 5 forward) afforded financial institutions. Moreover, ERTA also allowed nonfinancial corporations to use the extended period against losses incurred in 1976 and subsequent years, not just those incurred after 1981.

The loss of the superior combined carryover period has occurred at a time when such benefits would be most beneficial. The losses incurred by savings institutions from historically high interest rates clearly fall into the category of unique risks contemplated by Congress at the time special rules were originally granted. Special provisions for these entities are clearly warranted.

The Administration's 1985 tax reform recommendations propose applying prospectively the general corporate carryforward rules to thrifts. This denial of extended NOL carryover treatment for existing losses runs counter to the clear precedent established in 1981 under ERTA, as well as violating the congressional intent of the 1969 Tax Reform Act granting financial institutions a superior NOL treatment in recognition of the special safety and soundness concerns which are unique to depositories.

The general rationale for net operating loss carryback and carryforward is that a taxpayer should be able to average income and losses from a trade or business over a period of years to reduce disparities from fluctuating incomes. This rationale is particularly appropriate for thrifts whose long-term investment portfolios make their net income particularly vulnerable to sudden increases in interest rates. For financial intermediaries, the bottom line is the difference between relatively huge gross interest income and interest expense totals. Relatively minor savings in interest rate levels can produce huge changes in net earnings.

Full carryforward opportunty for net operating losses is especially important for institutions which have assisted the federal insurance agencies (FSLIC and FDIC) by participating in supervisory mergers—acquiring troubled institutions operating at substantial losses. Denial of equitable tax loss carryforward opportunities will further complicate the task of the FSLIC and FDIC in attracting future merger partners.

In addition, the important role of financial institutions within the business community requires that they be given at least net operating loss parity with other corporations, both in terms of aggregate years, as well as in the ability to utilize existing losses fully.

The U.S. League, therefore, recommends granting overall carryover period parity to thrifts by retaining our longer NOL carryback treatment and merely extending our NOL carryforward to a total of 8 years. The U.S. League strongly urges, as a matter of equity and to reflect the nature of the losses in the 1980 to 1982 period, that the existing net operating loss overhang be included in these revised NOL rules. A number of institutions facing the most servere NOL carryforward problem may even be attracted to the longer carryforward period of regular corporations, again provided that the longer period be made available for existing NOLs. In such cases, it would be appropriate to permit a one time, irrevocable option for institutions to elect regular corporate rules as regards NOL carryovers for all outstanding and future losses. This provision, with appropriate transition rules, would be of real value to a number of institutions and is fully consistent with the general concept of NOL offset. The overall thrust of tax reform is increased equity and efficiency. This NOL issue is one where the basic question is one of fairness: the outcome should not be revenue-driven.

The Administration's tax proposals would limit the use of the cash accounting method employed by virtually all savings institutions as well as a wide array of other service industries. Under this proposal, the cash accounting method would be limited to firms which have average annual gross receipts (over three years) of $5 million or less and do not use any other accounting method regularly to determine income, profit or loss.

Under the accrual method, generally speaking, income and expenses are recognized and deducted when incurred; the cash method recognizes income and deducts expenses when they are received or paid in cash or equivalent.

These new cash accounting restrictions would be effective for taxable years beginning January 1, 1986. However, taxpayers would be permitted to spread the income adjustment that results from the switch between the two accounting methods ratably over a six-year period.

The rational offered for this provision in the Administration package seems plausible on the surface but does have its weak spots. The Supreme Court has recently noted that there is no implicit presumption that financial accounting and tax accounting should be in conformity. In *Thor Power Tool Co.* v. *U.S.* 439 U.S. 522 (1979), the Court stated:

"The primary goal of financial accounting is to provide useful information to the management, shareholders, creditors, and others properly interested: . . . the primary goal of the income tax system, in contrast, is the collection of revenue . . .

Given this diversity, even contrariety, of objectives, any presumptive equivalency between tax and financial accounting would be unacceptable."

In addition, it is incorrect to assume that the Administration proposal would necessarily eliminate any discrepancy between the financial statement and the tax return. Even if both were on an accrual basis, significant differences, such as depreciation recognition, would remain. In fact, the above discussion on the proposed elimination of reserve accounting for bad debts represents an inconsistent movement in the Administration package away from accrual methodology.

Cash accounting is somewhat of a misnomer. Tax returns prepared on this basis do not completely follow a receipts and disbursements methodology—depreciation is a non-cash basis spreading of the cost of acquiring fixed assets used in the business. The major problem that Treasury has with the overall approach followed by cash basis taxpayers is the somewhat greater flexibility afforded.

Cash accounting does indeed provide thrifts with some important tax management alternatives not available under the accrual method. Moreover, an abrupt change from cash to accrual accounting would create an additional burden for thrift institutions at a time when they are struggling to restructure their portfolios and recover from the prolonged earnings squeeze which has weakened them The flexibility provided by cash accounting is important to the continuation and success of this recovery process.

In addition, thrift institutions would face another adverse financial statement impact from this tax law change if FASB adjusts the way that future tax liabilities should appear on the balance sheet.

Unlike the situation with the thrift bad debt reserves, deferred tax provision has been made for the timing differences produced between book and tax income from cash/accrual discrepancies. However, as Table 1 above shows, the statutory thrift rate has always been less than the 33% proposed in the Administration package. Under new FASB rules, it could become necessary to increase the financial statement provision for these timing differences to reflect the higher 33% rate.

The cash to accrual switch could thus have a financial statement impact of about $200 million. As a side-benefit of the restention of a modest 5% to 10% special thrift bad debt reserve addition, consistent with actual experience, this adverse impact would also be avoided.

However, even if the prejudice against the overall cash basis of accounting prevails, the league would suggest that a deeper analysis of the situation would argue for, at most, a limitation in the use of this method by savings institutions. The major legitimate reason the Treasury might have for opposing the use of the cash method is its potential for creating timing differences whereby one taxpayer's expense is not simultaneously picked up as another taxpayer's income. If expenses are recognized before income is declared, the Treasury is making interest-free loans of the taxes on the discrepancy.

Even though this may be a valid theoretical concern, for savings institutions the problem does not arise on the vast bulk of the transactions on either side of the balance sheet. As financial intermediaries specializing at the retail, individual taxpayer level, our cash basis business accounts interact with cash basis individual taxpayer returns.

On the savings deposit side, the vast bulk of our liability base, the constructive receipt doctrine and the countervailing deductibility of deposit interest expense as credited to accounts essentially produces a near-perfect match. On the asset side, the preponderance of individual mortgage loans owed by cash basis mortgagors gives an equal offset to our cash basis recognition of income thereon.

Any move away from the cash basis on the bulk of our assets and liabilities would, in effect, produce rather than eliminate the type of distortion intended by the switch to the accrual basis. A clear instance of the asymmetries caused by the accrual basis for our institutions is the problem created by applying the original issue discount (OID) rules to individual mortgage transactions by last year's tax act.

Under DEFRA, savings institutions would be placed on an accrual basis for certain purposes though borrowers would be limited to cash basis interest deductions. Consequently, lenders would accrue more income than borrowers could deduct as expense. Instituting asymmetries in favor of the Treasury is no solution to asymmetries against the federal revenues.

Analogous problems would arise from the present proposal to mandate accrual accounting generally.

The U.S. League recommends that savings institutions be permitted to continue the use of cash accounting for tax purposes. At the very least, this method should be retained for reporting income from currently held long-lived financial assets and the financed interest, origination points and deferred interest thereon. As with the elimination of reserve accounting and reserve recaptures, a significant financial accounting cloud hangs over the reform provisions. The financial statement damage could be out of all proportion to the revenue raised.

Finally, and to illustrate the interconnections of these issues, the forced switch to an accrual rather than a cash method of accounting could also require the recognition of taxable income which in fact may never be received. Since income is reported as accrued rather than as received and since on-going bad debt deductions are eliminated in favor of specific charge-off, institutions will be forced to pay taxes on fictitious income and defer any reversal of that tax charge until final uncollectibility can be proved. Such provisions can hardly be characterized as a movement towards greater fairness.

A major new element of the revised Administration package is the recapture of 40% of the excess depreciation claimed under the ACRS regime enacted by the 1981 tax act. Treasury argues that the timing difference produced by ACRS will, unless corrected, produce a significant windfall by accelerating deductions into a 40% rather than a 33% corporate tax regime. By triggering 40% of the timing difference of excess depreciation into the taxable income stream at a 33% corporate rate, the 13% difference between the 46% and 33% corporate tax rates is approximately offset.

Many commentators have criticized the meat-axe approach adopted by the Treasury in this area. The detailed criticisms have discussed the importance of the composition of the fixed asset portfolio on which excess depreciation is recaptured and the misapplication of the analysis to assets on which a substantial part of the return will be taxed at capital gains rates. We commend these points to the Committee's attention.

However, as far as savings institutions are concerned, a much simpler point must be made: the entire depreciation recapture process is predicated on a completely erroneous assumption of a 13% drop in the statutory tax rate from 46% to 33%. As far as we are concerned, the reform package as drafted would actually raise our statutory rate from 31.3% to 33%. For savings institutions, the excess depreciation recapture should be eliminated as completely as the recapture of past bad debt reserves. Closer examination of the particular circumstances or our institutions can show no basis for either of these punitive provisions.

As a final matter related to the purchase and expensing of capital asserts, in the event that any eventual tax reform legislation does not completely eliminate the investment tax credit (ITC), the League would like to draw the committee's attention to the inequitable treatment of saving institutions in that regard. The special thrift bad debt deduction is now effectively down to only 32% which would already argue for availability of more than the 50% value of the regular ITC currently available to our institutions. Obviously, to the extent that further cutback in this special bad debt provision is contemplated, compensating adjustments in any retained ITC program would be in order.

A similar point could be made as regards the availability of the current 85% and proposed 90% corporation to corporation dividends received deduction. We do, however, appreciate the institution of a limited 10% dividends paid deduction. As institutions increasingly move to stock from, this will offer some relief from double federal taxation of corporate profits.

A final area as regards our position as corporate taxpayers faced with a major recapitalization and restructuring task relates to special thrift reorganization rules. These rules were enacted in the 1981 Economic Recovery and Tax Act to permit the acquisition of a "financially troubled" thrift to qualify as a tax-free reorganization without regard to the continuity of interest requirement (Section 368(a)(3)(D)). This provision in the revised Administration package would until 1991 continue to permit an acquiring corporation to assume the failing thrifts' assets and liabilities in a tax-free reorganization without regard to continuity-of-interest. The same sunset date is provided for Section 597 which provides for tax-free treatment of certain FSLIC payments made to the acquiring corporation in connection with an acquisition.

These 1981 tax law changes were intended to assist the FSLIC in attracting merger partners for supervisory merger cases—thus assuring depositors that their funds were secure and minimizing payouts from the FSLIC fund. Thrift institutions remain exposed to interest rate fluctuations and are still only part-way through restructuring their balance sheets to enable them to compete in the unceraínty and volatility of the newly deregulated financial environment.

The U.S. League fully agrees with the President that the thrift industry has not fully recovered from the devastation of the 1981 and 1982 loss years. We, therefore, strongly support the President's decision to delay repeal of these important supervisory assistance Sections at least until 1991.

In fact, we would prefer Congressional review at that point rather than a definite sunset. Currently, we project rather healthy earnings in the aggregate for the business for 1985 and beyond but should a breakdown in the budget process unsettle financial markets and increase rates sharply, these projections could quickly require a downward adjustment. In addition, even though the business on average may rebound rather strongly, the FSLIC caseload may be slower to shrink and a hard and fast target of 1991 may be impossible to meet.

As a further point, we see no rationale for confining this type of merger facilitation to the FSLIC alone rather than to both FSLIC and FDIC assistance for troubled thrifts. Given the strains placed on the FDIC by the past few years, we would strongly support extension of these provisions to the FDIC assistance payments already made in the past and to be made in the future. Uniformity in these rules for all thrifts would be one beneficial example of tax code neutrality.

Finally, we come to the interaction of the proposed changes in individual tax laws with the position of savings institutions as financial intermediaries. The key issues here involve the federal deductibility of taxation imposed by lower levels of government.

A great deal of discussion has involved the impact on real estate values of the denial henceforth of the deductibility of local property taxes. The U.S. League shares these concerns as will be outlined in a moment but first it may be helpful to analyze another, little-appreciated implication of the non-deductibility of state income taxes.

Non-deductibility of these taxes will inevitably disadvantage all forms of taxable debt instruments vis-a-vis U.S. Treasury and agency obligations. Presently, wherever state or local income tax is levied, interest on federal obligations is exempt, just as municipal bond interest is in turn exempt from federal taxation. Savings accounts, though of virtually equivalent safety in view of the federal guarantee, must pay a somewhat higher rate, other things being equal, to cover the double bite of taxation imposed at both the state and federal levels.

That savings account rate spread to the equivalent maturity along the Treasury yield curve is narrowed by the federal deductibility of the state tax bite on the savings account interest. In effect, the federal tax bite is reduced in proportion to the marginal tax rate of the investor. If, however, the rules are changed so that no offset to federal tax liability is allowed for the state income tax bite, the yield spreads from doubly-taxed savings accounts to single-taxed U.S. obligations must widen. In effect, all rates must rise relative to the Treasury yield curve.

The net outcome of this phenomenon is hard to predict but it is simple to show that, for a marginal depositor/taxpayer in the top federal tax bracket facing 6% state income tax on a 10% savings account, the break-even increase in savings account yield is approximately 0.3%, i.e. a 10.3% yield will now be necessary to prevent a switch to investment in Treasuries. This paradoxical result occurs even though, with the drop in the federal rate from 50% to 35%, the depositor/investor would return more of the interest from the doubly taxed savings account. The problem is that the U.S. Treasury becomes relatively speaking a better deal because of its single taxation only.

To some extent, depending on supply and demand conditions in the savings market, this higher cost will come out of improving, but still fragile savings institution margins, reducing the accumulation of capital and the ability to provide financing. Also, however, since this is a general phenomenon, the rates on new mortgages will rise relative to Treasuries, first from attempts to pass along those higher savings costs, and, second, to attract the same level of funds in the now tougher competition with investments in Treasuries.

Intentionally or unintentionally, this provision will enhance the marketability of Treasury obligations at the expense of every other debt instrument, including mortgages. There is no guarantee that the general level of interest rates will fall enough to overcome this adverse impact on housing affordability.

Of course, the loss of the deductibility of property taxes would also adversely affect the after-tax cost of homeownership. Again, there is no guarantee that the presumed decline in mortgage interest rates from increased savings at lower tax rates will more than compensate for the loss of the property tax deduction. Even if interest rates do decline should the package be enacted "as is", that would provide little consolidation to current owners facing higher home occupancy expense unless that homeowner has an adjustable rather than a fixed rate loan. A contention that the lower income tax rates would always offset the loss of the property tax deduction is demonstrably untrue. At the very least, in a relative sense, housing would be a less attractive investment.

Certainly it has to be admitted that the exorbitant rates of return on highly-leveraged, fixed-rate financed real estate investment achieved in the inflationary era of the late 1970s could not and should not be sustained. In addition, some of the alarmist analyses of the impact of the loss of the property tax deduction may have gone overboard in predicting massive declines in real estate values. Nonetheless, given the fragile nature of both the housing recovery and the rather high delinquency rate already produced by the slowdown of inflation and the uneven geographic distribution of the recovery from the recession, even a 2-5% decline in relative real estate values could produce additional, unnecessary problems for both borrowers and lenders.

Foreclosures are clearly a human tragedy for the family dispossessed. But they are also a financial calamity for the lender. At a time when savings institutions are finally beginning to recover from the strains of inflation and recession, an added wave of asset quality problems would hardly be helpful.

Losses on real estate foreclosures appear this year to have tripled from historical levels. Should home values actually decline because of the loss of property tax deductibility, these losses could double or triple again. Nor is the condition of the FSLIC, even with the retention of the special assistance provisions, so strong as to enable additional problems to be handled routinely. Overall, we feel that the impact of the proposals on the real estate sector has been inadequately analyzed by Treasury and is a welcome subject for Congressional review.

Though the property tax deduction has received the lion's share of the attention, the inclusion of mortgate interest on second homes in the $5,000 plus investment income limitation on the other interest deduction may also already have had an impact on housing activity. Although second homes comprise perhaps only 3-4% of total activity, in certain regions the proportion is much higher. Nor are such purchases the exclusive domain of the ultra-wealthy. A further review of this limitation in the Administration package is in order.

The same goes for the revisions in the "at risk" and capital gains rules for commercial real estate. Again, a substantial proportion of rental property has benefitted from these provisions which the reform package would eliminate. An in-depth review of the impact of these changes prior to enactment is essential.

Savings institutions have played an increasing role in financing such properties. Some institutions have been extremely successful; a few have been much-publicized failures. The fortunes of neither extreme, nor of the vast bulk of institutions in-between, would be improved by these changes. Ultimately, the FSLIC is exposed when ventures involving FSLIC-insured institutions are involved.

Despite these reservations, the League does support two provisions in the Administration's program dealing with housing. The first is the elimination of the disruptive mortgate subsidy municipal revenue bond program. Though superficially attractive as a means of assisting the first-time homebuyer, these programs have been costly to the federal Treasury, inefficient providers of deep subsidies to a favored few, and insufficiently targeted to families needing special assistance for home purchase. If homeownership subsidy programs are to be continued, our League advocates more extensive use of the direct Mortgage Credit Certificates program authorized under DEFRA. That alternative provides a greater degree of borrower choice of both lender and loan type, and produces a more equitable dispersal of federal tax subsidy.

The second housing-related area where we endorse the Treasury package is in its revision of the installment sale rules. So-called "builder bonds" permit a lengthy deferral of taxation on profits from real estate sales, even though the builder/developer is effectively cashed out of the mortgage financing afforded to purchasers, because of the retention of the mortgage by the builder for legal, if not economic purposes. This practice represents a clear abuse of the permissible choice of tax accounting method and is overdue for correction.

The U.S. tax code has always been voluntary and, therefore, compliance becomes a critical factor in measuring efficiency and fairness. Without fairness and perceived equity, tax code compliance will be quickly eroded. Examples of tax code noncompliance, however, seem to be on the increase and, therefore, the U.S. League supports effective measures to improve compliance and reduce the growing underground economy.

An important element for improving tax code fairness, simplicity and compliance is the reduction in overall corporate and individual tax rates. Easing the perceived tax burden through lower rates improves voluntary compliance, reduces the attraction of shelter provisions and other tax avoidance schemes, and simplifies the existing code. We applaud the Administration for proposing lower corporate tax rates. Reduced corporate tax liability will in our view increase taxpayer compliance and stimulate economic growth.

The U.S. League also commends the President for his proposal to expand the spousal IRA contribution to the maximum $2000. The American housewife who usually works more than a full day in the home should not be denied the same retirement benefits of a wage earner working outside the home. The IRA account is one of the major inducements for long-term savings and spousal IRA parity will increase this important source of long-term capital.

The League, however, is disappointed by the recent Administration proposal to once again eliminate the popular 401(k) savings plan from the tax codes. The League had been encouraged by the reinsertion of the 401(k) in the set of changes made from the original November 1984 Treasury proposal to the May 1985 Administration package. Even though the May structure for the 401(k) integrated the IRA and 401(k) contributions within our overall ceiling, the added flexibility of the 401(k) is an attractive consumer benefit.

These plans represent a major private alternative to relieve the strains on the social security retirement system. We strongly recommend including the 401(k) and IRA proposals made by President Reagan last May in any tax code revision adopted by Congress.

This concludes the written testimony of the U.S. League of Savings Institutions. Our organization supports the Administration's recommendation for a maximum 33% corporate tax rate. We cannot, however, support the elimination of the thrift institution bad debt reserve (Section 593) and its replacement with a specific charge-off for bad debts. In particular we protest as unfair the Administration's proposal to recapture a portion of accumulated bad debt reserves. With regards to the net operating loss carryback/carryforward treatment of saving institutions, we recommend continuation of the 10-year carryback and extension from five to eight years of the carryforward to achieve parity with with the 18-year duration of carryback/carryforward now available to other corporations. The Administration's recommendation for mandated accrual tax accounting is inappropriate for depository institutions. The proposed elimination of the deduction for State and local taxes creates a special problem for private-sector financial intermediaries in the competition for retail deposits with U.S. Treasury issues. We were pleased when the Administration eliminated immediate repeal of special sections of the Code needed by the FSLIC in its resolution of supervisory cases; however, we urge your Committee to review the continued need for these provisions, rather than "sunset" them, in 1991. Finally, we call your attention to the work of House Banking Committee, which has pending for floor action legislation redefining a "qualified thrift lender" for the purposes of the financial institution statutes. Ideally, a consistent qualifying assets standard should apply for corporate tax purposes, as well.

I have appreciated this opportunity to present the views of the U.S. League of Savings Institutions and look forward to your questions.

STATEMENT BY W. DEAN CANNON, JR., PRESIDENT, CALIFORNIA LEAGUE OF SAVINGS INSTITUTIONS, LOS ANGELES, CA

Mr. CANNON. Mr. Chairman and members of the committee, my name is Dean Cannon. I am president of the California League of Savings Institutions. I would like to offer my written statement for the record and simply summarize that statement at this time.

Our membership in California collectively holds some 25 percent of the assets in the savings and loan industry, and I appreciate this opportunity to present our membership's deep concerns about the impact of the administration's tax proposal on the future of this industry.

In addition, I would like to say at the outset that the California League shares the concerns expressed earlier by Mr. Morris on behalf of the nationwide industry.

Our membership is very concerned that proposals to entirely revamp the taxation of the savings industry have been made and may be considered by Congress in the name of tax reform without any regard for the economic impacts this proposal would have on our industry or for the regulatory requirements that are imposed on the industry.

We recognize that the tax proposals generally have a far reaching effect, and this committee has heard and will hear from many groups. We believe, however, that the savings industry is and has historically been recognized as a very unique segment of the American economy, as an instrument to foster residential home ownership, and would be adversely affected by the administration's tax proposal in a rather dramatic way.

The industry is now placed between the provervial rock and a hard place. Tax policy members of the administration suggest in the tax-reform proposals that the savings industry should immediately diversify out of residential mortgages and be taxed as any other business. At the same time, the regulators and the congressional banking committees are saying that the legislation is necessary to ensure the industry's continued commitment to residential mortgage lending. The administration wants to assure that dedication for home mortgage interest, to encourage home ownership, and yet it is telling the primary supplier of mortgage funds to invest elsewhere.

The savings and loan industry is already in frail health. We fear that the financial impact of the pending tax proposals and the imposition of conflicting regulatory and tax policies about the very nature of the savings industry may result in irreparable harm. The irreparable harm comes from not only the added tax costs of one increasing the industry's effective tax rate by the elimination of the industry's special bad-debt reserve deduction, but two causing the industry to repay or recapture past tax benefits granted for the industry's already fulfilled commitment to housing, but also from the impact of these proposals on the industry's balance sheet, the cost of doing business.

While it is true that various tax liabilities that would result from the proposal could be spread over a period of years, such is not the case with financial and immediate financial regulatory accounting which would require full and immediate recordation of those liabilities.

The sum of these liabilities would have the immediate effect of reducing the industry's net worth, and the magnitude of this net worth reduction could well approach all of the industry's tangible net worth. It is likely that this impact would jeopardize the solvency of certain institutions and adversely affect our Federal Deposit Insurance system. At the very least, it will impair the health of numerous institutions, reduce their ability to raise sorely needed capital, their ability to earn public confidence in our system generally.

The direct and indirect tax impacts of the proposal are of no small significance, either. The industry is concerned about elimination of special net operating loss carrybacks presently in place for the industry, as well as the ineligibility of existing losses that qualify for any new carryforward, the proposed requirement to accrue income loss before receipt, and the significant additional cost of competing with Government for investment dollars as a result of proposed elimination of State and local tax deductions.

In addition, the proposals adversely affecting housing threaten the value of the security underlying our investments.

We would like the opportunity to work with the committee to determine what aspects of tax reform can fairly and reasonably be applied to the industry. To that end, we are continuing our study of these issues and would ask that you keep the record open so that we may have the opportunity to submit further data as we are able to collect them.

I thank you, Mr. Chairman, for the opportunity you have given me this morning to present the California League's position with respect to this matter, and I would be happy to try to respond to any questions you may have.

The CHAIRMAN. Thank you, sir.

Mr. Perkowski.

[Mr. Cannon's written testimony follows:]

STATEMENT OF W. DEAN CANNON, JR.
PRESIDENT, CALIFORNIA LEAGUE OF SAVINGS INSTITUTIONS

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE, My name is Dean Cannon, and I am president of the California League of Savings Institutions. I am pleased to have the opportunity to appear before this Committee.

Collectively, the members of the California League hold approximately $250 billion in assets, which amount represents approximately 25 percent of the savings industry's assets nationwide. In California, approximately 80 percent of our members' aggregate assets constitute "qualifying" assets under the present definition for savings and loans under the Internal Revenue Code. Moreover, approximately 70 percent of our members' aggregate assets consist of actual investments in residential mortgages. In addition, California savings institutions are responsible for financing 57 percent of home purchases in California.

Given the California League's representation of a very significant portion of the savings industry, I appreciate being able to present to you our membership's deep concerns about the impact of the Administration's tax proposals on the future of this industry.

At the outset, our membership is very concerned that proposals to entirely revamp the taxation of the savings industry have been made and may be considered by Congress in the name of tax reform, without any regard for the economic impact such proposals would have on the industry or for the regulatory requirements which are imposed on the industry. We recognize that the tax proposals generally have a far-reaching effect and that this Committee has heard and will hear from many groups. We believe, however, that the savings industry is, and has historically been recognized as, a very unique segment of the American economy, and would be affected by the Administration's tax proposals in a unique way.

The industry is now placed between the proverbial rock and a hard place. The tax policy members of the Administration suggest in the tax reform proposals that the savings industry should immediately diversify out of residential mortgages and be taxed as any other business. At the same time, the regulators and Congressional banking committees are saying that legislation is necessary to ensure the industry's continued commitment to residential mortgage lending. The savings industry is already in frail health. We fear that the financial impact of the pending tax proposals and the imposition of conflicting regulatory and tax policies about the very nature of the savings industry may result in irreparable harm.

We hope that this Committee will have the opportunity to consider fully and carefully the consequences of any proposed tax legislation on the future of the savings industry. The California League is prepared to work with you toward this end.

In my statement today I would like to review the proposed tax changes for the industry in light of (1) its historical tax structure, (2) its current economic and regulatory environment, and (3) the very real threat the proposed changes would pose for an already ailing industry.

I. HISTORICAL PERSPECTIVE

Savings and loan associations first emerged in the nineteenth century as a means of financing home ownership for people with limited financial resources. Community groups pooled their resources into associations, and each member of an association, as the resources of the association permitted, borrowed from the pool in order to acquire a home. Of course, savings and loans have changed somewhat since that time. However, the primary purpose of savings and loan associations remains unchanged: to enable Americans to become homeowners.

Unlike other entities, including commercial banks, savings institutions have historically been in the unique position of "lending long" (long-term residential mortgages) and "borrowing short" (short-term and demand-type deposits). Notwithstanding recent legislative changes, the industry basically remains a long-term housing lender. Congress, for more than 80 years, has encouraged the savings industry to assume this financial position to assure the availability of residential mortgage funds in order to fulfill a very vital national need for housing. This long-standing system established by Congress has and continues to be very effective as reflected by the industry's commitment to mortgage lending. Technical commentators tend to gloss over the fact that the tax proposals represent a very fundamental change away from this existing national policy of encouraging home ownership through the assurance of mortgage funds.

Because savings institutions make loans on 30-year mortgages and at the same time borrow on short-term deposits, the industry is subject to the great risk of fluctuating interest rates. As Congress observed in 1982:

> The high and volatile interest rates of recent years have illustrated starkly the inherent dangers of borrowing short and lending long at fixed rates.[1]

Congress has appreciated this risk and long ago recognized the need to encourage institutions to take such risks by establishing a special tax regime for savings institutions that concentrate investments in residential mortgage loans.

Since the inception of the Federal income tax, savings and loans have been granted unique tax treatment. Until 1951, such institutions were not subject to tax. Since 1951, Congress has maintained a special tax structure for the industry in recognition and encouragement of its commitment to residential mortgage lending.

Under current law, savings and loans that commit 82 percent of their assets to specified housing-related assets are subject to the general corporate tax, but are allowed a special deduction in arriving at income subject to tax. Savings and loans may deduct additions to bad debt reserves equal to a maximum of 40 percent of taxable income.[2] The net effect of this special deduction under current law is to bring the effective industry tax rate down to approximately 31 percent for those institutions committed to residential mortgage lending.

---

[1] S. Rep. No. 97-536, 97th Cong., 2d Sess., Depository Institutions Act of 1982, Rept. of Comm. on Banking, Housing, and Urban Affairs to accompany S. 2879, p. 13 (Sept. 3, 1982).

While denominated a "bad debt deduction," this special allowance for savings institutions differs materially from ordinary corporate or bank bad debt deductions in nature as well as amount. The risks which the reserve is designed to protect against are not only the risks of non-performing loans -- as is the case with other businesses -- but also the additional risk of interest rate fluctuations and other risks associated with long-term residential mortgage investments.

Current tax law also recognizes the long business cycles to which savings institutions are subject by virtue of the limitations on their investments. Since 1969, savings institutions have been afforded a special ten-year carryback and five-year carryforward of their net operating losses ("NOLs"). Congress expressly stated in 1969 that this special carryback period was designed to minimize the danger of an unexpected surge of losses,[3] and the special carryback provisions have in fact fulfilled their intended purpose.

---

[2] A savings and loan whose qualified assets fall below the 82 percent test (as set forth in Internal Revenue Code ("IRC") § 7701(a)(19)) is still permitted a deduction, the amount of which decreases as qualified assets decrease. Institutions whose qualified assets fall below 60 percent, however, are not entitled to any deduction for additions to loss reserves. IRC § 593(b)(2)(B).

During the unprecedented interest rate climb of the early 1980s, savings institutions suffered enormous losses as a result of the need to pay high rates on deposits while earning low rates on locked-in mortgage portfolios. The losses were of such magnitude that in the period from 1980 to 1984 approximately 510 of the approximately 4,000 FSLIC-insured savings and loans did not survive and were subject to regulatory bail-outs.[4] In 1982, 252, or 7.5% of FSLIC-insured institutions, failed. In 1984 an additional 877 insured associations were insolvent or nearly insolvent under the minimum regulatory net worth requirement (three percent of RAP net worth).[5] Absent the ability to carry those losses back and realize immediate tax refunds many additional institutions would have needed regulatory assistance, thereby further endangering the viability of FSLIC.

---

[3] H. Rep. No. 413, 91st Cong., 1st Sess. 128-29 (1969), reprinted in 1969 U.S. Code Cong. & Ad. News 1645, 1779.

[4] Barth, Brumbaugh, Sauerhaft, & Wang, Insolvency and Risk-Taking in the Thrift Industry: Implications for the Future 5 (June 20, 1985).

[5] Id. at 6.

II. CURRENT TAX PROPOSALS

The Administration's current tax reform proposals state the obvious by noting that existing law "distorts" investment decisions and serves as a "disincentive" for thrifts to diversify their assets.[6] The Administration's observation is unremarkable as this is precisely what Congress designed the current system to do. The tax proposals would instead eliminate any special tax provisions for thrifts and would tax them under the scheme proposed for corporations generally. As I will explain below, the premises upon which the proposals are founded are faulty. Allow me first to outline briefly the actual proposals.

1. Elimination of Bad Debt Reserve Deductions. Under the Administration's proposals, the notion of reserve accounting for bad debts for tax purposes is rejected entirely for all taxpayers. Rather, the proposals would permit a bad debt to be deducted only when such debt has actually become worthless under a so-called "specific charge-off" method. The net effect

---

[6] The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity 239 (May 1985).

of this proposal is to increase the industry's tax rate to 33%. As previously noted, the existing bad debt reserve deduction is a mechanism for reducing the industry's tax rate.

2. Recapture of Existing Reserves. In moving from a reserve method to a specific charge-off method of tax accounting for bad debts, the proposals call for a "recapture" of existing reserves, *i.e.*, taxpayers would be required to take certain amounts previously deducted into income.

The proposals contain only a limited recognition of the fact that the bad debt reserves for savings and loans represent the historic special tax regime for those institutions established in exchange for a commitment to residential lending. The proposals would require savings and loans to recapture that portion of their existing reserves which they would have been allowed to maintain had they computed their reserves as though they were commercial banks. Savings institutions could recapture such amount in one year or spread the recapture over ten years. The balance would not be recaptured and would be recognized as the historic special subsidy to the industry. Treasury has not articulated the precise reason for tying the suggested recapture to the commercial bank formula, or even a precise formula for computing the amount of reserve recapture.

3. NOL Rules. In carrying out its stated purpose of "leveling the playing field," the Administration proposes to change the net operating loss deduction period for savings institutions from 10-years back/5-years forward to 3-years back/15-years forward, as is now in effect for the general corporate community. In so doing, the Administration would not permit existing savings institution losses to be eligible for the new carryforward period. (This is directly contrary to the treatment of existing losses accorded other corporate taxpayers when their carryforward was extended to fifteen years under the Economic Recovery Tax Act of 1981 ("ERTA")).

4. Other Proposals. The savings industry would suffer adverse financial and business consequences as a result of various other of the Administration's proposals. For example, the proposals to deny deductions for state and local taxes would significantly raise the cost of competing for depositors' funds with U.S. government obligations, which are exempt from state and local taxes.

Under other provisions of the proposed tax package, savings institutions, together with certain other taxpayers, would be required to recognize income long before receipt under a proposal to mandate accrual rather than cash accounting. The significant income arising from the transition from the cash to accrual method could be spread over a six-year period.

Other proposals would have both direct and indirect effects on the savings industry. The Administration's proposals would affect savings and loans directly by repealing as of 1991 recently enacted provisions liberalizing the tax rules governing acquisitions of financially troubled savings and loans. The numerous tax proposals having an impact on the real estate and housing industries would affect the value of savings institutions' existing mortgage portfolios as well as the prospects for continued residential mortgage lending. Additionally, proposals to implement a "clawback" of depreciation deductions affect the savings industry disproportionately because the proposals are keyed to a reduction in the general corporate tax rate, while the savings industry's tax rate would increase under the proposals.

Our purpose here today, however, is to focus primarily on the first three proposals outlined above which would most directly and adversely affect the savings and loan industry. Taken together, we believe that these proposals would have a most severe economic effect on the industry and its federal insurance system underpinnings.

III. THE PROPOSALS THREATEN THE NET WORTH OF THE INDUSTRY

The Administration's proposals do not reflect any consideration or understanding of the industry or the broad economic impact of their effect on the industry. In a much narrower context, the proposals do not even provide specific estimates of their tax impact on the savings and loan industry, so that their actual tax/revenue impact is difficult to determine.

Therefore, in an effort to explore the full impact of the proposals on our industry, the California League has asked Peat, Marwick & Mitchell to undertake an economic study of the impact of the proposals on the industry.[7] Peat Marwick's conclusions (attached hereto) demonstrate the grave threat the proposals pose for

---

[7] Based upon that firm's own survey of the industry in California.

the California segment of the industry. We believe that same threat is posed for the industry generally.

The industry's major concerns are what the tax proposals mean for the industry's future, the availability of funds for home mortgage lending, the federal insurance system, and depositors.

The tax proposals would not only increase tax burdens prospectively but would generate "retroactive" taxes on the industry as a result of the "recapture" and transition rules. Based upon the Peat, Marwick study, it appears that California institutions would be required to recapture bad debt reserves in an amount of $442 million. Extrapolating, we would estimate recapture for the industry would amount to $1.768 billion.*

It is anticipated that, notwithstanding the ability to spread this income over a period of years for tax purposes, financial and regulatory accounting would require the industry to record the full liability immediately. Because of the unique nature of the industry's tax bad debt reserve, which has been acknowledged as a special industry tax rate subsidy, there is no corresponding book reserve[9] to be charged for the proposed tax change. The recapture tax would therefore cause an immediate reduction of net worth.

---

* Since California represents approximately 25 percent of industry assets, we have multiplied the California figure by 4 to estimate the national figure.

Further proposed tax changes, which effectively raise the industry's tax rate, would result in additional immediate financial accounting adjustments of $729 million for savings institutions in California and an anticipated $2.916 billion for savings institutions nationwide -- again directly and immediately diminishing net worth.

Net worth, or capital, is obviously the heart of any industry. It is of particular significance to this industry where regulators spell out the breadth of permitted activity (including the extent of permitted liabilities which translate into earnings capacity) on the basis of net worth. Moreover, in an industry in need of massive capital infusion, analysts rely on net worth measures. Reduced net worth means a reduced confidence in the system and reduced ability to attract necessary capital.

The industry computes its net worth both on a regulatory basis ("RAP" net worth), and on a generally accepted accounting principle basis ("GAAP" net worth). Under either calculation, by far the most substantial component of the industry's net worth is its intangible assets. Tangible net worth, i.e., the value of assets producing earnings, is calculated as GAAP net worth, less amounts for goodwill and other intangibles.

---

[9] See Financial Accounting Standards, APB Opinion No. 23.

In an independent study, economists associated with the Federal Home Loan Bank Board calculate tangible net worth as .39 percent of the industry's total assets for 1984.[10] Against the industry's assets of approximately $1 trillion for 1984, tangible net worth would amount to approximately $4 billion.

The immediate and direct effect of the changes occasioned by the tax proposals would be the entire elimination of this tangible net worth.

Regulatory authorities require that savings and loans maintain RAP net worth at least equal to three percent of assets. In California, Peat Marwick predicts that, as a result of the proposed tax changes and their financial consequences, approximately 30% of institutions polled would fall below this regulatory standard, resulting in a severe curtailment of those institutions' permissible activities and in supervisory control.

---

[10] Barth, Brumbaugh, Sauerhaft & Wang, Insolvency and Risk-Taking in the Thrift Industry: Implications for the Future 4 (June 20, 1985).

The proposals would surely render some institutions insolvent, bringing the FSLIC's insurance function into play. Even for those institutions that would remain solvent and above the three-percent benchmark, their future viability as well as their ability to assist the FSLIC in absorbing troubled thrifts would be diminished. Commentators have already suggested that FSLIC's potential liabilities today are three times its assets. Clearly many institutions and the FSLIC could not withstand these further adverse effects on net worth.

Congress has historically recognized its responsibility to look beyond the immediate tax effect of proposed amendments to the tax law to determine the full scope of the impact of such amendments. This requires peripheral vision. The Administration's proposals would have a wholly unwarranted and punitive tax impact on the savings industry -- but the tax impact is only part of the problem. The even greater, broad economic impact that the proposals would produce raises serious questions about the industry's ability to survive.

IV. THE TAX PROPOSALS ARE FUNDAMENTALLY INEQUITABLE

The tax proposals are fundamentally inequitable in the broad sense that an industry required to commit itself to specified long-term housing finance should not be taxed like any other industry free to make rational market choices.

In a more focused context, the proposals are inequitable in many specific respects from a tax policy perspective.

1. Increased Tax Rate. While the Administration's proposals are designed in general to lower the tax burden for other industries, the Administration would increase the tax burden on the savings and loan industry. At the very least, the current tax burden on savings and loans should not be increased. The industry is locked into long-term mortgage portfolios built in reliance upon existing law.

2. "Transition" Changes. The various "transition" proposals which are supposed to put savings and loans on an equal footing with other taxpayers are unfair and, in fact, punitive.

First, the bad debt recapture proposal is tantamount to a retroactive tax. The bad debt deduction for savings institutions has, historically, been a quid pro quo for mortgage lending and has not been tied to non-performance of loans as such. Accordingly, "recapture," which might provide the appropriate transition between accounting methods in other contexts, is inappropriate from a policy standpoint here. Irrespective of the tax structure for the industry on a future basis, this industry should not be penalized by being required to pay back its past tax rate reduction. It has already paid for any benefits granted by limiting itself to specified investments. Moreover, the existing tax structure has already been figured into the determination of the industry's borrowing costs and return on funds lent. Should any new system be adopted for the future, it should be adopted on a fresh-start basis; Congress should clearly specify that reserves resulting from the industry's historic commitment to mortgage lending are free and clear of tax.

And, even if any recapture were appropriate for this industry, the proposals argue that recapture is intended merely to prevent a double deduction of actual bad debts that could occur upon the switch from a reserve to a "charge-off" method of accounting (e.g., a specific bad debt anticipated by a reserve addition prior to the switch would be deductible if it became worthless after the switch). By proposing that savings institutions recapture the equivalent of hypothetical bank bad debt reserves, the proposals are entirely arbitrary and would constitute a penalty to the extent they would tax more than the industry's actual bad debt experience and not exempt the balance of reserves from any tax.

Second, the proposed NOL rules would not only remove a very necessary loss carryback provision for the industry, but, by excluding existing losses from the operation of new carryforwards, treat savings institutions less favorably than other industries have been treated upon carryforward extensions.

3. Accrual Accounting and NOL Rules. The substantive accrual accounting and NOL proposals totally ignore the posture and sensitivity of the savings industry.

Cash reporting is both fair and correct from an economic and tax perspective for this industry. Moreover, the Administration's proposals for accrual accounting fail to achieve their stated purposes of reflecting economic income, matching income and expense, and conformity with financial accounting. First, taxing income not received runs totally counter to the time value of money concept and puts taxpayers such as savings institutions at a severe disadvantage in comparison to other industries which can defer the accrual of future income through the election of installment reporting. Second, in the case of savings institutions whose primary source of income is individual's residential mortgage interest, the individuals are deducting payments on the cash basis, thus preventing a mismatch of income and expense reporting. Third, the Administration's selected concerns about tax/book accounting conformity are belied by its general proposals for the elimination of reserve accounting and have otherwise been rejected by the United States Supreme Court.[11]

With respect to NOLs, we submit that savings institutions should have no less than the full 18-year deduction period afforded other taxpayers; however, the breakdown between carrybacks and carryforwards must, of necessity, be different. The need for longer carrybacks in this industry is well-established, and Congress has historically recognized that need. Current losses should be eligible for the extended carryforward period as they were when the period was extended for taxpayers generally.

---

[11] Thor Power Tool Co. v. United States, 439 U.S. 522 (1979).

4. Other Proposals. The proposals to eliminate deductions for state and local taxes would adversely affect the savings industry in several ways. The cost of borrowing funds will increase because savings institutions will be subject to greater competition for depositors' funds from U.S. government obligations, which are exempt from state and local tax. Accordingly, the savings industry will have to offer depositors a greater yield to compensate for the fact that interest will be subject to state tax which will not be deductible.[12]

In addition, these and other proposals would have a significant impact on housing and would therefore adversely affect the housing industry and the property securing savings and loans investments.

---

[12] The California League estimates that a savings institution would have to offer a rate of 12.03% in order to compete with a Treasury bill paying 10% if the proposals were enacted, as opposed to the 11.24% necessary to compete under current tax law. At the same time, the spread between an institution's income and expense may further narrow to the extent its income is dependent on interest from adjustable rate mortgages which are pegged to Treasury obligation rates.

V. THE TAX PROPOSALS ARE PREMATURE AND INAPPROPRIATE AT THIS TIME

As we have already observed, the Administration's tax proposals are designed to eliminate the special tax system for savings institutions which presently operates as a disincentive to diversification and subjects savings institutions to increased portfolio risk. The special tax system was designed by Congress to operate precisely in this manner, and the existing composition of the industry's assets attests to its effectiveness.

The notion that savings institutions should be taxed immediately as though they could or should make free investment choices is completely misguided.

First, the industry has been and will continue to be heavily regulated. At the same time as Treasury advocates diversification, the Federal Reserve Board and the Federal Home Loan Bank Board are urging Congress to legislate stricter regulatory tests requiring savings institutions to commit a substantial portion of assets to housing finance. (See H.R. 20, as ordered reported by the House Committee on Banking, Finance, and Urban Affairs, June 18, 1985.) The principal purpose of such a so-called "housing finance" or "thriftness" test is to force savings institutions to fulfill their role as primarily mortgage lenders, notwithstanding the recent enactment of legislation affording them broader powers.

During the last Congress, the Senate Banking Committee in reporting out a bill similar to H.R. 20 said of thrifts:

> The Committee intends by this test to ensure that thrifts remain committed to housing lending, which has been their basic purpose and continues to be the principal reason for them to continue to enjoy the substantial tax and other benefits that apply to thrifts.[13]

The ill health of the industry is no secret. The experience of institutions which have departed from the industry's principal purpose has made the headlines repeatedly. Recent savings and loan failures have strained the federal insurance system -- perhaps, according to published reports, to and well beyond its limits.[14]

The uncertainties for the industry are great. It makes little sense to promote diversification for savings institutions in a tax bill, while banking bills are moving in the opposite direction. The Treasury's proposals exhibit no consideration whatsoever of the current regulatory or economic environment in which savings institutions exist. At the very least, sound federal policy demands a coordinated approach to chart the industry's future.

---

[13] S. Rep. No. 98-560, 98th Cong., 2d Sess. 15 (July 17, 1984) (Report to accompany S. 2851).

[14] See Washington Post, July 3, 1985, at A16, Col. 1.

Even absent conflicts with regulators and the banking committees, however, the tax proposals are wholly unrealistic. They presuppose that, upon enactment, the industry will be free to make unbridled investment choices. By its very nature, the industry is locked into long-term portfolios which it cannot transform, without great difficulty, into such investments as the market dictates.

We do not understand the Administration to have departed from the basic and historical expectations for the savings industry, i.e., a commitment to housing, and safety and soundness. In fact, the Administration's commitment to the deductibility of mortgage interest reflects a continuing policy of encouraging home ownership. Yet, this commitment requires a further concern about the supply of mortgage funds. The tax policymakers, on the one hand, and the regulators on the other, are sending opposite messages to the industry responsible for assuring the availability of those funds.

The current tax reform proposals jeopardize fulfillment of these basic expectations for the industry.

CONCLUSION

In conclusion, we underscore the need to search for a tax reform blueprint that will not unduly penalize industries in the name of achieving a "level playing field." Moreover, the need for housing and affordable residential mortgages must be recognized. The President, in his speech unveiling the tax reform package, proclaimed that the reforms would help Americans to achieve their "American dream." Surely home ownership is a major part of that dream. However, the proposals affecting savings institutions could make it impossible for many Americans to own their own homes. Increasing the tax burden on the savings industry, and in addition penalizing the industry for past tax incentives accorded it by Congress, could be most unfortunate for the federal deposit insurance system, for depositors, and for the American public generally.

Tax reform cannot be viewed in a vacuum. The status of financial institutions is in a state of flux and Congress should not make drastic changes in the tax code without considering overall policy goals with respect to financial institutions, their investments and the role they should play in our economic system. Any consideration of tax changes should accompany a full consideration of more wide-ranging banking and regulatory issues.

We would be happy to work with the Committee to determine what aspects of tax reform can fairly and reasonably be applied to the industry. To that end, we are continuing our study of these issues and would ask that you keep the record open so that we may have the opportunity to submit further data as we are able to collect them.

Thank you, Mr. Chairman, for the opportunity you have given me to represent the California League of Savings Institutions here today. I would be happy to respond to any questions you may have.

STATEMENT BY JOSEPH PERKOWSKI, PRESIDENT, MINNEAPOLIS FEDERAL EMPLOYEES CREDIT UNION, MINNEAPOLIS, MN

Mr. PERKOWSKI. Mr. Chairman and members of the committee, I am pleased to be here today to present the views on credit union taxation.

The credit union movement today is currently made up of 18,100 credit unions, and we have approximately 53 million members.

I personally have been involved with credit unions since 1960, and for the past 7 years I have been president of the Minneapolis Federal Employees Credit Union, a $68 million organization serving 25,000 Federal employees and their families in Minneapolis.

Unlike other credit unions, Mr. Chairman, our primary purpose is service to our members, not profit for our stockholders; and because of this, decisions are made in credit unions which differ from those of other institutions. The different decisions themselves are the cornerstone of the credit union movement.

In the brief moment of these hearings, we must somehow demonstrate the present nature of the credit union financial system and its very people-orientated 50-year history. In the same moment, we must also convince you that reversing present credit union tax policy could forever remove the nonprofit consumer orientation which presently drives the credit union movement.

When credit unions were organized 50 years ago, they qualified for their tax-exempt status because they were operated on a nonprofit basis. They had no capital stock, they were mutually controlled—that is, one member, one vote—they were directed by volunteers, and most of them had very close relationships with their sponsoring companies. Well, all those conditions still exist today.

However, Mr. Chairman, it is becoming increasingly clear that the decision before Congress is not whether credit unions qualify for the exemption—which I feel they do—but whether the exemption is still warranted. I personally have no doubts whatsoever that credit unions are contributing more today than ever and that the exemption continues to be warranted.

Boiled down, the exemption has come to symbolize the public policy understanding between the credit union movement and the Federal Government. In exchange for a small amount of possible revenue loss by exempting credit unions from taxation, there has been returned an abundance of social benefits far in excess of any revenue loss. The exempt status has a lot to do with it, and let me try to explain very briefly.

First, the boards of directors of credit unions make decisions based on member needs, not on bottom-line needs.

The CHAIRMAN. Not on what needs?

Mr. PERKOWSKI. Bottom-line needs—tax-orientated needs, profit-orientated.

Second, Mr. Chairman, the exemption has existed for 48 years. It was reaffirmed in 1951 and again in 1961 and it has become an important part of the movement to retain the image and respect of that status. We are actually motivated through the pride of accomplishment and the fear of the loss of that exemption. As a result of it, we have kept our purpose constant.

Third, the combined results of the credit union principles and the Federal policy have produced a fully completed financial system at no cost to the Government, which is in excellent health and offers over $100 billion in consumer loans to its members.

Ironically, Mr. Chairman, the brunt of taxation would likely be borne by the marginal segment of the credit union population. Each credit union has its younger members, its members on fixed income, its elderly members, and it is this group who would possibly lose some of the services or begin to pay fees on services of small loans, people getting loans who couldn't get them elsewhere, of loans being carried sometimes for months and years until fortunes are reversed, free financial counseling, free transportation to the credit union for the elderly, free life savings insurance, loan protection insurance, share drafts, and the list goes on and on and on. We are afraid taxation would do away with some of those stories.

We contend, Mr. Chairman, it is not possible to simply extract a small amount of tax revenue from credit unions and leave everything else untouched.

Treasury-II sets a threshhold of $5 million. That tells us that credit unions are credit unions until they pass this magic asset level of $5 million. But we feel that large credit unions do not lose their philosophy just because they achieve a certain asset level, and to prove that point I would like to just relate very briefly some of the operating policies of the largest credit union in the United States, the Navy Federal Credit Union, which is not too far from here.

Mr. Chairman, that credit union has 135,000 accounts of less than $10; it has 180,000 of less than $100; it serves its members 24 hours a day, 365 days a year, and on last Christmas Day they made 50 loans while we were at home eating turkey.

In closing, very simply, I would just like to reemphasize two points: First, it is not possible to extract a little tax revenue and leave everything else untouched; and second, as long as credit unions continue to return social benefits far in excess of any revenue loss, it makes sense to maintain such an arrangement.

Thank you, Mr. Chairman.

[Mr. Perkowski's written testimony follows:]

STATEMENT OF

JOSEPH PERKOWSKI

Mr. Chairman, members of the Committee, I am pleased to be here today to present my views on credit union taxation. The credit union movement in this country is presently composed of 18,500 credit unions serving over 52 million members. The proposal before us today would reverse present credit union tax policy and thereby alter the fundamental nature of the entire credit union movement. The movement, its trade associations, its credit unions, and its individual members are united in a total commitment to preserve this unique non-profit consumer-oriented sector of the financial services arena.

I personally have been involved in the credit union movement since 1960. I am presently serving as Chairman of the Credit Union National Association, Inc. For the past seven years, I have been the President of the Minneapolis Federal Employees Credit Unions. This credit union has $68 million in assets and serves 25,000 members. Like other credit unions, our primary purpose is service to our members; not profit for stockholders. Because of this, decisions are made in credit unions which differ from those in other institutions. These different decisions are themselves the cornerstones of the credit union movement. They are, if you will, the credit union story and they form the basis for our case to preserve the tax exempt status.

In the brief moment of these hearings, we must somehow demonstrate the present nature of the credit union financial system and its very people-oriented 50 year history. In the same moment, we must also convince you that reversing present credit union tax policy would forever remove the non-profit consumer orientation which presently drives the credit union movement. On this particular issue, my role here today is to represent the 52 million members of credit unions in this country, as there is no doubt that credit union members would be hurt by taxation. In this regard, we are most encouraged that other organizations, such as the Consumer Federation of America, have joined in the effort to preserve the credit union movement as it presently exists. I would ask, Mr. Chairman, that a statement from Mr. Stephen Brobeck, Executive Director of CFA be placed in the record.

Bases For Credit Union Exemption

Present federal law provides federal credit unions with an exemption on their income at both the federal and state level. It also provides state chartered credit unions with an exemption at the federal level. Most state laws also give state chartered credit unions an exemption.

The Federal Credit Union Act was enacted in 1934 to establish a "national system of cooperative credit to make more available to people of modest means credit for provident purposes." The tax exemption for federal credit unions was omitted in the original 1934 Act. However in 1937, after encountering an onerous burden of taxation by the states, Congress granted an exemption on the basis of their non-profit organization and to help ensure the success of the movement. A more detailed historical accounting of the credit union tax exemption is contained in Enclosure (1).

Credit unions qualified for their tax exempt status based on being organized and operated on a non-profit basis. They have no capital stock, are mutually controlled (one member-one vote), are directed by volunteers, and most have close relationships with sponsoring companies. These conditions remain true today.

However, Mr. Chairman, it is becoming increasingly clear that the decision before the Congress is not whether credit unions qualify for an exemption (which they do), but whether the exemption is still warranted. I personally have no doubts whatsoever, that credit unions are contributing more today than ever and that the exemption continues to be warranted. This assessment was borne out in our recent hearing and activities with the Ways and Means Committee where, incidentally, credit unions and their members have quite convincingly presented their case. In short, the message was that credit unions were making invaluable social contributions in every district and that the tax exemption was a uniquely contributing factor.

The Tax Exemption Is Pivotal to the Credit Union Story

The reason for this is part economic, part historical, part circumstance, and part the intended result of a policy decision. Even within the credit union movement itself, the full realization of how central a role is played by this exemption was only recently reached. Due to the severity of the present tax threat, credit union representatives conducted widespread taxation seminars around the country. As a result of these wide ranging discussions, a fuller appreciation was reached concerning the critical importance of the exempt status. Because of this, the involvement of the credit union movement in the tax fight became widespread and is growing.

Boiled down, the tax exemption has come to symbolize the public policy understanding between the credit union movement and the Federal government. In exchange for a small amount of possible revenue lost by exempting credit unions from taxation, there has been returned an abundance of social benefits far in excess of any revenue loss. The exempt status has a lot to do with it. Let me explain:

First and foremost, credit union boards presently make decisions purely on meeting the needs of members; they are free from the artificial influence of the tax code.

Second, the tax exemption has existed for 48 years. It was re-affirmed in 1951 and 1961. It has become important for the movement to retain the image and respect of this exempt status. Therefore, we are motivated both through pride of accomplishment and fear of losing the exemption. Both cause decisions and actions which are in the credit union member's favor. The very existence of the exemption preserves the practice of the basic credit union principles.

Third, the combined results of credit union principles and Federal policy have produced a fully completed financial system at no cost to the government which is in excellent health and which offers a reliable and rapidly expanding source of low cost consumer credit (presently over $100 billion). This system is dedicated by law to the extension of consumer credit.

The Impact of Treasury II

The Treasury II proposal would remove the tax exemption of credit unions of $5 million or more in assets. This proposal would tax 85% of the movement's assets and 75% of its members. Additionally, it would cause a most damaging effect to the presently unified credit union movement by dividing it into "taxed" and "untaxed" sectors. Further, Treasury II would open the door to taxation by the states on all sized credit unions. Table I shows, by asset size, the impact of taxation on credit union earnings transfers.

As if to compound matters, the brunt of taxation would likely be borne by the marginal segment of the credit union population. In contrast, the more affluent members of each credit union would probably be "inconvenienced" by taxation. They would complain about a fee increase or a decline in their savings rate; some might transfer their funds elsewhere; but their quality of life wouldn't really be hurt. Unless fees were dramatically raised, some might never notice the difference. But each credit union has its younger members just starting out, or the elderly on fixed incomes, or a group with an economic disruption such as a strike or a plant closing. Additionally, some of our credit unions, such as community development credit unions, serve neighborhoods and areas of predominantly lower income persons. These are the areas where we very clearly see the credit union uniqueness; the difference that makes it a movement and not an industry. And these are the areas directly impacted by taxation. Here we see the litany of credit union stories--people getting loans who can't get them elsewhere; loans being carried for months and years until fortunes are reversed for some members; free financial counseling; free transportation to the credit union for elderly members; free life savings and credit disability insurance; and on and on. Practically every credit union could provide this Committee with stories about such practices.

In the state of Oregon, for example, the Clatsop-Tillamook Teachers Federal Credit Union set up a senior citizens club to help the elderly in Tillamook. This $9.5 million credit union has 4,700 members and offers to seniors an account with free checking, free Travellers checks, and free financial counseling to set up budgets. Also in Oregon is the Providence

Portland Employees Federal Credit Union. This $1.6 million credit union serves the Portland hospital and has 1,700 members. It works very closely with the sponsoring hospital on all employee-related activities. It works directly with the Employee Assistance Program of the hospital to assist employees whose job performance is suffering due to financial problems.

On the east coast in the state of New York, the Campbell Soup Company Employees Federal Credit Union serves 240 locations of Campbell Soup Company nationwide. Like many credit unions, they offer financial counseling, no-cost matching life insurance on savings (up to $5,000) and free life insurance on loan balances up to $25,000. In the last four months, they made 100% real estate loans to four low income people in order that they could buy a home in the $30,000-$45,000 range and at a rate of 13.5%. There is no pre-payment penalty nor were there any points on these loans. They were made so that these people might enjoy the benefits of home ownership they could never obtain elsewhere. This fine credit union is aggressively participating in the effort to prevent the burden of taxation from falling on its members.

In between these coastal areas in the state of Iowa, we see how a particularly painful impact of taxation would occur to credit unions serving areas that are yet to participate in any form of economic recovery. One such town is Esterville, Iowa. This one-industry town is comprised mainly of employees of the John Morrell Company, a meat packing company. Four years ago, it was forced to close its beef packing plant. Just this April, it was forced to close its pork packing plant. The Morrell-Esterville Employees Credit Union has provided service since 1947 and is actively participating in helping its members through these very rough times. It has re-written practically every loan on its books. It is providing financial counseling and establishing stringent family budgets. It continues to provide free Life Savings Insurance and Loan Protection Insurance. It has no service charges on share draft accounts. There are hopes the plant may open again. The credit union is trying to carry its members until the horizon brightens. Every tax dollar assessed on that credit union will take from a person who is already experiencing serious difficulties.

For your further information, we have assembled in Enclosure II a collection of recent credit union actions contributing to the well-being of constituents from most of the states represented by the members of this Committee.

Taxation Would Do Away With Such Stories

You can correctly conclude that we contend taxation would put an end to many of these every day credit union practices. And we can understand how you might have reservations accepting this contention. But we honestly believe that if we could convey to you the relationships and principles which have combined to form the credit union system, you would clearly see the devastation from the unintended side-effects of taxing this movement. We contend that it is not possible to simply extract a small amount of tax revenue from credit unions and leave everything else untouched. In my judgement, our whole case rests on decision-makers understanding the differences between the credit union system and those of the banks and savings and loans. We ask you to study our testimony closely and to meet with the credit union members and managers who will be requesting the opportunity to tell their story. If you can, visit some credit unions in your states and see first-hand what would be the real losses from taxation.

On the matters of safety and soundness and basic lifeline services which we set forth in subsequent pages of this testimony, we ask that verification be sought from both Chairman Garn and the Banking Committee as well as the federal regulatory agency, the National Credit Union Administration.

Social/Economic Benefits of Tax Policy

Mr. Chairman, the following list of social benefits are derived in large part from the federal policy which has existed toward credit unions. The keystone of this policy is the tax-exemption.

o The credit union financial system is in excellent financial condition.* Because of its willingness to manage its own problems, there exist no major potential Federal liabilities. This is not true of other systems.

- Through mutual self-help, there is now in place a separate system to meet the liquidity, regulatory, information, and insurance needs of all credit union members.

*See 1984 Annual Report of the National Credit Union Administration.

- Close personal service is given to all members regardless of their income or size of accounts. This includes financial counseling and the promotion of good credit and savings habits. Basic lifeline services are always available to members of credit unions.

- There are over 250,000 volunteers serving as directors and committee members in these institutions. 33% of all credit unions have no full-time employees.

- Over 52 million American consumers are receiving financial services from over 18,300 credit unions (50% are under $1 million in assets).

- American consumers receive convenient and low cost services from their credit unions. Lower loan rates are available to members because of lower cost of operating credit unions. This is achieved in a large part by serving only members, because board members are not paid, because they are non-profit, and because of close sponsor relationships.

- In 1984/85, the credit union system used its resources to fully capitalize their central bank and their Federal insurance fund (NCUA). This action reduced the Federal deficit by $1 billion. If credit union growth is not interrupted by taxation, estimates show that further capitalization will reduce the Federal deficit an additional $1 billion by 1990 and by the year 2000, a total reduction of $9.2 billion.

- The credit union system has stressed credit union cooperation. It is not based on credit union competition. Like the other systems, it has been subjected to severe economic shocks. A crisis of confidence has been avoided because of working together.

Disruptions from Policy Reversal of Tax Policy

In our judgement, the following actions would occur within the credit union system if it were taxed. Obviously, the individual actions of credit unions will vary. But overall, I am convinced the credit union movement will suffer the following disruptions and the impact will be permanent.

- The safety and soundness implications are seriously troublesome. Since credit unions have no capital stock, they must use their undivided earnings as a means of preparing for major changes or unexpected market forces. The impact of the Treasury II plan on overall credit union equity would be devastating. For example, if the plan had been in effect during the period 1979-84, the cumulative reduction in overall equity (reserves and undivided earnings) would have been 20%. In other words, taxation would reduce the present equity level of the credit union movement from 7.1% ($8.1 billion) of assets to 5.7% ($6.6 billion). This is at a time when the FDIC and the Federal Reserve are recommending an increase in the minimum capital level for banks to 9% and when the S&L industry is desperately seeking new forms of capital. Potential Federal government liability to guarantee the soundness of credit unions is dramatically increased.

  Further, taxation has to strike at the heart of the system's willingness to take care of its own problems and, instead, look to the Federal government for protection and continuance of its share of the financial market.

- In order to minimize the impact of taxation, individual credit union managers will be forced to adopt a tax avoidance strategy. All management decisions will be tempered by their tax implications. Almost instantly, credit union management will become "profit-driven."

- Pressure will mount to eliminate free and "unprofitable services." Small loans, financial counseling, low balance share draft (checking) accounts, and no-fee accounts are obvious potential victims of such pressures.

- To seek out the more "profitable" accounts, pressure would soon arise to permit credit unions to establish a traditional business relationship with the general public.

- As part of this trend, we will likely see the loss of the volunteer force within the movement as a direct result of taxation. The loss of volunteers and the volunteer spirit could be one of the most expensive social costs of taxation.

- The overall financial condition of the system will feel the impact of collective decisions to increase yield by increasing risk. This danger is minimal in a "member-driven" system which accounts, in a signifi-cant part, for today's relative health in the credit union movement.

- The financial and paperwork burdens of Federal taxation will be exacerbated as individual states assert their prerogatives to impose their form of credit union taxation.

The Committee should also be aware of the financial reform implications of taxation. Taxation will force a shift in credit union management philosophy from service (or member) driven to profit (or tax avoidance) driven. Once this occurs, it will be entirely appropriate to expect a series of requests for credit union legislative changes. A preliminary assessment leads me to suggest some of the following: some method of raising capital stock; the ability to convert to stock ownership; the ability to pay all board members; a method to eliminate free and unprofitable services or accounts (this would probably best be accomplished by having different classes of membership and/or by eliminating the membership concept and simply establishing a traditional business relationship with the general public); and certain new investment authorities to permit the chance for higher yields on investments. Finally, I am sure we will want to rethink the capitalization of the National Credit Union Share Insurance Fund if the premiums became tax-deductible. As you can see, the real cost of taxation will not be measured just in dollars.

The Inevitability of Credit Union Taxation?

The 25 years I have spent in the credit union movement have left me with a sincere appreciation of the dedication and spirit of the workers and volunteers who give so much to help their fellow members. Because of these years, I am unwilling to concede the inevitability of the necessity for credit union taxation. To do so is both to fault the original granting of the exemption and to deny the value to the country of the credit union contribution.

Detractors contend that a credit union loses its merit for tax exemption when it grows to a certain size. This contention suggests that a credit union could somehow avoid growing into a taxable situation. Unlike banks or S&Ls, credit union growth often occurs as a direct result of sponsor growth. Take for example, the credit union in this building--The Senate Employees Federal Credit Union. I would estimate that it is twice as big as it was 7 or 8 years ago and the main reason is because of the increase in employees.

The largest credit union in the country is Navy Federal Credit Union. It has over $1.9 billion in assets. Yet, it is probably one of the least likely credit unions to deserve taxation. It is large because it serves over 684,000 members all over the world. This credit union has 135,000 accounts of less than $10 and an additional 180,000 less than $100. It is open 24 hours a day, 365 days a year (50 loans are made on a Christmas day). There are no minimum balance requirements and no fees for a wide range of basic financial services which are made available to all members. In fact, over 43% of all transaction accounts are under $100, are paid generous dividends, and are charged no fees. Since the majority of its members are enlisted, it concentrates on accumulating savings and thereby making credit available on reasonable terms to persons who otherwise couldn't get it. The fine record of this credit union hardly justifies removing its tax exempt status. It was able to retain the basic credit principles while reaching substantial size. Many other military credit unions are quite large and are also providing vital services to our servicemen and women. It seems totally counterproductive to impose a tax on this group of credit unions because of their size.

Unfair Credit Union Advantage?

We often encounter the contention that credit unions have an unfair advantage, and they should be forced to play on the proverbial level playing field. Well, first of all, the credit union advantage is a consumer advantage. People have an advantage through their credit union. There is not an inner group of stockholders and officials which benefits personally from the success of the credit union. Second, the real credit union advantage comes from the non-profit structure, the volunteers, the close sponsor relationships, and the mutual ownership. Third, a healthy financial system is hardly an unfair advantage and certainly not one to consider removing. Fourth, the Federal Reserve Bulletin of June 1985 shows that credit union's percentage of the total savings market was only 4.8%. Their share of the consumer installment debt (credit) had fallen from 17.1% in 1976 to 15.1% in February 1985. For further reference, total credit union assets are less than those of Bank of America. Finally, a recent General Accounting Office report concluded that "...overall, credit unions are not a serious threat to...(their) taxed competitors."

Occasionally, it is suggested that the tax exemption should be removed because a credit union is offering a service that was not available when the tax exemption was granted. There are certain obvious points that must be made regarding this contention. First, the powers which credit unions received since the tax exemption was granted were ancillary to consumer savings and lending. They did not move credit unions away from their basic purpose. They were, of course, granted by Congress but were not granted with the proviso that the tax exemption was at stake. Second, in a 48 year period, most business practices change drastically. Credit unions weren't offering credit cards, for example, when they received their tax exemption because such cards hadn't been developed yet.

Can't Just Tax Credit Unions

In closing, I would like to re-emphasize two points: first, that it is simply not possible to extract a little tax revenue and leave everything else untouched; second, that as long as a credit union continues to return social benefits far in excess of any revenue loss, it makes sense to perpetuate such an arrangement.

The Administration's plan justifies keeping some exemptions in the tax code. These include the home mortgage deduction, special treatment of Social Security and veterans' disability benefits, and itemized charitable deductions. The Administration explains retaining these tax preferences on the grounds that "they are widely used and generally judged to be central to American values." Credit unions clearly fall into this general category. Their exemption is 'widely used' by 52 million people to further habits of thrift, prudent borrowing, and volunteer service. Their stories abound with examples of traditional American values.

I thank you for the opportunity to appear here today. I will be glad to answer any questions.

Origins of Credit Union Tax Exemption

In 1917, the Secretary of the Treasury requested that the United States Attorney General render an opinion regarding the income tax liability of credit unions organized under the Massachusetts Credit Union Act of 1915. In a November 1917 ruling, the Attorney General declared his opinion that Massachusetts credit unions (and by inference credit unions in other states as well) were exempt from federal income tax because of their similarity to cooperative banks and building and loan associations (as they were organized and operated at that time). The opinion declared in part:

> "The similarity between credit unions and cooperative banks, as they exist in Massachusetts, is striking. Having in mind the history of the insertion of the fourth paragraph, section 11 of the income tax law, it must be conceded that although credit unions do not come within the letter of the paragraph, such associations are wholly within the intention and meaning of Congress as therein expressed. Because the words 'credit union' were not specifically used is certainly no reason for saying that such organizations are subject to the tax imposed by the act, if on examination of the purpose and the object of such associations it appears that they are substantially identical with domestic building and loan associations or cooperatives 'organized and operated for mutual purposes and without profit.'"

ENCLOSURE I

The Commissioner of the Internal Revenue ruled in June 1935 that, upon proper certification from the supervisory agency, federal credit unions would be granted exemption from federal income tax. In 1937, Congress adopted amendments to the Federal Credit Union Act, primarily to provide federal credit unions with relief from state taxation, but specific exemption from federal taxation was also included. The original Federal Credit Union Act (1934) permitted states to tax credit unions on the same basis as banks. This was generally done on the basis of share capital. Since by law credit unions do not accept deposits, all shares were vulnerable to taxation. The tax burden became so oppressive, the Congress established the policy (mentioned above) of tax exemption in 1937.

Federal credit unions also derive tax exemption directly from the Internal Revenue Code (26 U.S.C. § 501(c)(1); *see also*, Rev. Rul. 55-133, 1955-1 C.B. 138). Section 501(c)(1) exempts corporations organized under an act of Congress, if such corporations are instrumentalities of the United States and, if, under the enabling act as amended or supplemented, those corporations are exempt from federal income tax. The original FCU Act specified that federal credit unions would act as fiscal agents of the United States upon request of the Secretary of the Treasury (12 U.S.C. § 1767). That provision, under which federal credit unions were and are still deemed federal instrumentalities, provides another basis for the exemption from federal income taxation. Both the Internal Revenue Service and the courts have affirmed that federal credit unions are federal instrumentalities.

FEDERAL CREDIT UNIONS

Chapter 14 of Title 12 of the United States Code, as amended to January 12, 1983

§ 1751

Short Title.—This chapter may be cited as the "Federal Credit Union Act" (June 26, 1934, § 1, 48 Stat. 1216; Sept. 22, 1959, § 1, 73 Stat. 628).

Act of June 26, 1934, cited to the text was entitled "An Act to establish a Federal Credit Union System, to establish a further market for securities of the United States and to make more available to people of small means credit for provident purposes through a national system of cooperative credit, thereby helping to stabilize the credit structure of the United States."

Title I—General Provisions

§ 1768 § 122

Taxation.—The Federal credit unions organized hereunder, their property, their franchises, capital, reserves, surpluses, and other funds, and their income shall be exempt from all taxation now or hereafter imposed by the United States or by any State, Territorial, or local taxing authority; except that any real property and any tangible personal property of such Federal credit unions shall be subject to Federal, State, Territorial, and local taxation to the same extent as other similar property is taxed. Nothing herein contained shall prevent holdings in any Federal credit union organized hereunder from being included in the valuation of the personal property of the owners or holders thereof in assessing taxes imposed by authority of the State or political subdivision thereof in which the Federal credit union is located; but the duty or burden of collecting or enforcing the payment of such a tax shall not be imposed upon any such Federal credit union and the tax shall not exceed the rate of taxes imposed upon holdings in domestic credit unions. (June 26, 1934, § 18, 48 Stat. 1222; Dec. 6, 1937, § 4, 51 Stat. 4; Sept. 22, 1959, § 23, 73 Stat. 637; Oct. 14, 1970, Pub.L. 91-468, 84 Stat. 1015.)

Credit Union Activities

Summarized below are examples of credit union activities which typify the social benefits derived from the credit union movement.

Kansas

The Super Chief Credit Union of Topeka, Kansas has traditionally adopted a policy of providing low loan rates, good dividend rates, and involving members in the decisions affecting the credit union. Over 200 members signed a recent letter to their congressional delegations urging removal of credit unions from the tax refor proposal.

Pennsylvania

The $70 million Philadelphia Federal Credit Union was one of the first financial institutions to install special braille-equipped automated teller machines for its visually handicapped members. The North Pittsburg Telephone Employees Credit Union has been offering interest-free loans to members who were victims of the tornados that recently ravaged parts of Pennsylvania. Additionally, the $92.5 million Philadelphia Telco Credit Union offered interest free loans to all other telephone credit unions whose members suffered tornado losses. A good example of large credit unions helping other credit unions.

ENCLOSURE II

New York

Union Settlement Federal Credit Union serves East Harlem, one of New York City's poorer neighborhoods. "With nowhere else to turn except to a neighborhood loan shark or a high-interest credit store, we are the community's alternative economic system," the credit union's former president, Maria Rodriguez, told New York Magazine. To wit, the credit union makes loans to welfare recipients--to whom no one else will lend--and has discovered they have a substantially lower delinquency rate than many other borrowers. The credit union has helped a local nursery school struggling to pay its taxes. It assisted in rebuilding an indoor ethnic stall market, after the 112th Street complex was ravaged by fire 10 years ago. More recently, the credit union helped a local development group renovate abandoned brownstones.

The New York Team Federal Credit Union of Hicksville, New York serves present and retired employees of the Long Island Railroad and the Metropolitan Transit Authority. Established group rates for members on auto, homeowner, and life insurance by making free automatic payments from member's accounts. Pays 7.75% on regular savings with minimum balance of $25. Taxation would force re-assessment of all these policies.

Texas

Windthorst is a small farming community in North Central Texas. It is so small that it has no banks--the only financial institution serving the town is the $10 million Windthorst Federal Credit Union. Every Monday, the credit union sends a staff member to the community's one school to accept deposits and issue withdrawals to school children ranging in age from 6 to 16.

Missouri

The Holy Rosary Credit Union outside of Kansas City has specialized in providing service to immigrants for over 40 years. Presently, it is helping Vietnamese who could not find credit elsewhere. Over the years, it did the same for Italians, Cubans, and Mexicans.

Minnesota

The Hmong American Community Federal Credit Union of St. Paul may be unique even for credit unions. It is run by and serves refugees from the Hmong tribe of Southeast Asia. The credit union is trying to teach tribe members the basic trust in a financial institution and thereby alter the practice of keeping all their money in their homes.

New Jersey

The Episcopal Diocese of Newark started a credit union to serve poor urban areas as a natural outreach program for the churches in this diocese. The Episcopal Federal Credit Union provides credit to many who could not find it elsewhere.

Arkansas

Jones Mills Federal Credit Union of Jones Mill serves the employees of the Reynolds Company. The plant is subject to periodic layoffs. When that happens, the credit union has a policy of carrying the laid-off workers who have borrowed from the credit union and does not consider them delinquent.

Hawaii

Hawaiian Telephone Employees Federal Credit Union in Honolulu has $46 million in assets. In late 1982, a hurricane hit the island chain. It was the Wednesday before Thanksgiving. The hardest hit was Kauai. Five Hawaiian telephone credit union people flew to Kauai. They made loans to members on the spot for relief--no questions asked. They cashed share drafts, per diem checks, and overall went through $5,000 in cash. On Sunday, they flew back to the credit union in Honolulu and then back to Kauai on Monday with more cash. Its members are telephone company employees, with membership on several islands.

Oklahoma

The World and Tribune Federal Credit Union of Tulsa has $14 million in assets. It makes a special effort to serve the needs of retired members by holding seminars for them several times each year. These generally include a luncheon and a guest speaker on such topics as financial management, legal matters, legislation concerning retirees, etc. The credit union also has a policy of waiving loan payments and advancing loans to members who are laid off.

Louisiana

The Firestone Lake Charles Federal Credit Union is located in Sulphur and has assets of $3.5 million. It serves employees of the Firestone tire company which has experienced heavy layoffs. This credit union actually plans for these layoffs and builds up reserves so it can continue to provide services to members through the crisis and waive payments on loans taken out by laid-off members.

Colorado

The Denver Florists Federal Credit Union assisted a member who owned a greenhouse and who ran into serious financial problems operating it. He was about to lose everything when he came to the credit union for advice. They decided to help him and they set up a budget planning session. He agreed to turn over all his income to the credit union and they dealt with all his creditors. They charged him no fees. They also took over the first trust on the greenhouse and worked with him for a few years until things turned around. He eventually sold the greenhouse at a nice profit.

CASE I
PRESIDENT'S TAX PROPOSAL
1984 Data

GROSS INCOME: includes all income (including non-operating income)
NET INCOME: allows exclusion of operating expenses (excluding provision for loan losses), dividends, interest payments and net loan charge-offs
TAXABLE INCOME: equals net income
TAX RATE: marginal rates rising from 15% to 33% of taxable income
TAX AVOIDANCE POTENTIAL: Minimal
TREASURY REVENUE (1984): $350 million

		For Credit Unions Paying Tax:				
Asset Size ($ Millions)	Percent of Credit Unions Paying Tax	% With Tax Greater Than Transfers to Undiv. Erngs	% With Neg. Transfers to UDE Paying Tax	Tax as Percent of Gross Income	Tax as Percent of Transfers to Undivided Earnings	Average Tax
$ 0.0 - 0.2	0.0%	0.0%	0.0%	0.0%	0.0%	$ 0
0.2 - 0.5	0.0	0.0	0.0	0.0	0.0	0
0.5 - 1.0	0.0	0.0	0.0	0.0	0.0	0
1.0 - 2.0	0.0	0.0	0.0	0.0	0.0	0
2.0 - 5.0	0.0	0.0	0.0	0.0	0.0	0
5.0 - 10.0	94.6	7.4	6.5	2.8	37.5	23,600
10.0 - 20.0	94.8	9.8	4.4	3.3	46.4	55,700
20.0 - 50.0	96.0	14.0	6.5	3.3	51.4	120,500
50.0 & Over	98.7	16.5	5.5	3.2	56.2	432,300
TOTAL	19.3%	10.4%	5.8%	3.2%	50.9%	$ 98,800

Formula

Gross Income
- Operating Expenses
+ Provision for Loan Losses
- Net Charge-Offs
- Dividends & Interest
= TAXABLE INCOME

TAX RATES

Taxable Income	Tax
Below $25,000	15% of Taxable Income
$ 25,000 - $ 50,000	$ 3,750 + 18% of Taxable Income over $25,000
$ 50,000 - $ 75,000	$ 8,250 + 25% of Taxable Income over $50,000
$ 75,000 - $140,000	$14,500 + 33% of Taxable Income over $75,000
$140,000 - $360,000	$35,950 + 37.66%* of Taxable Income over $140,000
Over $360,000	A flat 33% of Taxable Income

* The Treasury Plan contains no specific details on how CUs with incomes of $140,000-360,000 should calculate their tax liability. However, CUNA economists recommend using 37.66% to calculate their potential tax liability. This figure accommodates the anomaly which occurs at $360,000 when the graduated rates abruptly end and the entire income is suddenly subjected to the 33% rate.

TABLE I

Run Date: May 19, 1985

STATEMENT ON
"CREDIT UNION TAXATION"

BY

STEPHEN BROBECK
EXECUTIVE DIRECTOR
CONSUMER FEDERATION OF AMERICA

SUBMITTEED TO THE SENATE COMMITTEE ON FINANCE
HON. BOB PACKWOOD, CHAIRMAN

September 26, 1985

The Consumer Federation of America (CFA) appreciates the opportunity to submit written comments on the impact of the tax reform proposal on credit unions. CFA is the nation's largest consumer advocacy organization, representing over 200 national, state, and local consumer, cooperative, farm, labor, rural and senior citizen organizations, which together represent over 30 million people.

Credit unions and the credit union movement are a unique force in our economy. They pioneered and continue to make available the most consumer-oriented financial services available. Credit unions have continued to provide these basic services to their members even as the financial system as a whole has undergone a rapid series of bewildering changes, leaving most consumers with higher costs and less reliable information on which to base decisions.

Credit unions have responded to these changes in the market because they are different from other financial institutions. Credit unions are operated on a not-for-profit basis and as democratically controlled membership organizations. Their relationship with their members contrasts sharply with the relationship between profit-driven financial institutions and their customers. As banks and savings and loans withdraw from low and moderate income markets, the services provided by credit unions have become even more essential to the consumers other institutions don't want.

The proposal to tax credit unions poses a serious threat to the essential nature of the credit union movement and would result in the curtailment of many of these consumer benefits. Since there are no profits to tax, the proposal would tax the income from which credit unions set aside federally required reserves, as well as the retained earnings used for additional reserves. Because credit unions are more narrowly based than other financial institutions, they need flexibility to absorb changes in local economic conditions. At a time when the basic health of many parts of the financial system is open to question, and is maintained largely through the investment of federal government resources, it seems irresponsible to take an action which could threaten the safety and soundness of another segment of that system, and thus risk the need for further government intervention to preserve these institutions.

The safety and soundness implications of this proposal are serious, but we have even greater concerns about the implications for consumer services. Credit unions would have no choice but to curtail the advantages they are able to offer their members: lower interest rates on loans, low or no fees on deposit accounts, free financial counseling, or higher savings rates. In fact, the Treasury proposal actually suggests that this is how credit unions should adjust their operations to pay the tax.

At a time when Congress is seriously considering legislation to cause others to treat their customers as credit unions do, we find it totally counterproductive to alter the fundamental nature of a credit union. The values brought to the financial marketplace by credit unions should be encouraged, not eliminated.

We have heard the argument that the proposal merely ensures that credit unions and banks can compete on an equal footing. But unlike banks, credit unions are limited to providing consumer services to a limited market. The entire credit union movement has about the same assets as the largest single bank in the United States. Credit unions serve their own members, and thus rarely compete directly with other financial services providers. Credit unions were created, and still exist, to serve consumers who are largely ignored by the rest of the industry. We have different types of financial institutions because they have different primary missions. While those differences have become somewhat blurred in recent years, it is important to remember and maintain those fundamental differences. There is nothing to be gained -- and much to be lost -- by making credit unions function just like banks.

Credit unions which are taxed may eventually look more like banks -- but they will look like very weak banks with no profits to cushion them and a restricted base of customers and services. Neither consumers nor, ultimately, the U.S. Treasury, will benefit from turning credit unions into pale imitations of commercial banks.

If anything, Congress should consider how to make banks behave more like credit unions, instead of the other way around. In the meantime, the proposal to tax credit unions simply threatens the one small portion of the financial market which is most oriented to serving consumers and in which consumers have the greatest control over the conditions of their service. The resulting revenues will be small at best, and probably nonexistent if the federal government is called upon to rescue a weakened credit union movement.

Credit union leader girds for battle

Perkowski fights for tax exemption

By Jim McCartney
Staff Writer

Depending on your point of view, Joe Perkowski may have picked the wrong year to be chairman of the Credit Union National Association.

Perkowski, 49, the president of the Minneapolis Federal Employees Credit Union since 1978, is leading the national credit union trade group in what he and others call the biggest battle credit unions have faced in nearly a quarter of a century: the fight to retain their exemption from federal taxes.

The Treasury Department's tax proposal calls for withdrawing the exemption for all credit unions with more than $5 million in assets.

"It's the overriding issue. It's the most critical issue we've ever faced," said Perkowski, who has been involved with credit unions for 25 years and is a past chairman of the Minnesota League of Credit Unions.

Although Perkowski's style is calm and reasoned, his words reveal a certain zeal when it comes to credit unions. For instance, he speaks of the 18,300 credit unions in his association not as an industry, but as a "movement." He describes his constituency as the credit unions' 52 million members, not customers.

His campaign against federal taxation will take up most of his time during his term as CUNA chairman, which started in May and runs through October 1986 — unless he decides to run for a second term. The typical chairman spends about 160 days working for the credit union organization; Perkowski expects the tax fight will require him to spend as many as 240 days in that role.

> **"If we are taxed, then we'd have to become more like a bank. We don't want to be like banks."**
>
> Joe Perkowski
> National credit union trade group

Perkowski worries that eliminating the tax exemption will undermine the basic purpose of credit unions — providing affordable financial services for a broad range of members — and will hurt their financial stability.

In his testimony before Congress, Perkowski cites numerous examples of credit unions providing low-cost or free financial services to people who might not be able to find or afford those services at other financial institutions.

Among those examples is his own credit union's response in 1981 when President Reagan fired the air traffic controllers who went on strike. His credit union had 289 air traffic controllers as members. Those members held $1.5 million in consumer loans and $250,000 in mortgages at his institution, which now has $68 million in assets and 25,000 members.

"We met with them and worked with each member," Perkowski said. "Only five went bankrupt, and we had to write off about 7 percent of those loans. The rest are doing

Please see Perkowski/3H

SEE NEXT PAGE

[illegible]

The tax issue [illegible] the [illegible] vice president of CUNA.

"It could change the nature of credit unions," [illegible] said.

Perkowski's [illegible] may be particularly [illegible] Thursday when he testifies before the Senate Finance Committee. Next to him will be representatives of the bank and savings and loan trade associations, who will argue that since their members have to pay taxes, so should credit unions.

Arguments for taxation

Banks and thrifts argue that the tax exemption gives credit unions an unfair competitive advantage, which is also the underlying argument in the Treasury Department's reasoning.

> **"[illegible] is that all financial institutions should be taxed equally."**
>
> Mark Olson
> Fergus Falls banker

"Our position is that all financial institutions should be taxed equally," said Mark Olson, the president of Security State Bank of Fergus [illegible] president of the ABA in 1986.

"No institutions, including credit unions, ought to have special exemptions, particularly when they have been allowed to diversify and branch out."

Perkowski downplays the competition. Credit union charters restrict members to the individuals and their families who come within the common bond of the credit union. Although the common bond often is a sponsoring company, such as Northwest Airlines, it also can be types of workers, such as Perkowski's credit union, and communities, such as the Ely area. Furthermore, Perkowski em-

[illegible] that [illegible] of all the credit unions in the country [illegible] than the total assets of Bank of America or Citicorp. Credit unions account for less than 5 percent of all the nation's savings at financial institutions and slightly more than 15 percent of the consumer loans, the main business of credit unions.

Perkowski argues that credit unions deserve the tax-exempt status because of the unique role they fill in the financial world.

"If we are taxed, then we'd have to become more like a bank," Perkowski said. "We don't want to be like banks."

Potential fallout

Credit unions now base their [illegible] adopt profit-oriented strategies. They might eliminate free or unprofitable services. And they might be tempted to lobby for expanded sources of profit, such as commercial loans, which would detract from consumer lending, he said.

Taxing credit unions would threaten their financial stability, Perkowski said, becuase untaxed earnings now go into credit union reserves to ensure against loan losses. As a result, the credit union industry as a whole has stronger reserves than either the banking or savings and loan industries.

The Treasury argues that by taxing net income, credit unions would have the incentive of distributing more of their pre-tax income to members, rather than holding it as retained earnings.

Action could haunt

"It's an incredible argument," Perkowski said. The small amount [illegible] at credit unions [illegible] already [illegible] a good [illegible] sharing their earnings with members; they don't need to be prodded into it by the goal of tax avoidance, he said.

Deposits at credit unions are insured by the National Credit Union Administration's insurance fund, a federal agency. Perkowski argues that any erosion of financial stability at credit unions could come back to haunt the federal government, which is ultimately responsible for the safety of deposits at credit unions.

The first major test for the bill will be when it comes for a vote before the House Ways and Means Committee sometime this month, Perkowski says. But even if it is voted down, Perkowski will continue the fight.

"I'll have to spend as much time as it takes until we win," he said. "You never know when it will be resurrected in another committee."

The CHAIRMAN. Mr. Perkowski, in terms of the operation of a credit union, you are not adverse to good management and making profits, or what I would call profits, for disbursement to your depositors, are you?

Mr. PERKOWSKI. No, we are not, sir.

The CHAIRMAN. In terms of the theory of the structure of your ownership, how do you differ in that sense from a mutual savings bank?

Mr. PERKOWSKI. Well, we are a cooperative, a financial cooperative. We are nonprofit, and it is one member, one vote, Mr. Chairman. I am not that familiar with mutual savings banks, but our members at our annual meeting, regardless of the size of their deposits, only have one vote.

The CHAIRMAN. Well, mutual savings banks in theory are nonprofit in the sense that you referred to it as dividends or something for stockholders. They have no stockholders; they have depositors. Mutual insurance companies have policyholders; they don't have shareholders as stock companies do. I am trying to follow the theory of why you should be treated differently simply because you are in essence a mutual form of organization owned by depositors rather than a stock form of organization owned by shareholders.

Mr. PERKOWSKI. Well, in 1951 Congress took a look at that and for some reason or another lifted the tax exemption of mutuals, and credit unions retained theirs. And in just studying the history, it appears that the reason it has is because we have continued to do what we were charged to do, and that is fill that void and serve the consumers. And our policies have not changed, our membership has not changed, and we contend we are still doing that today.

The CHAIRMAN. Make no mistake, I like credit unions. I served on the Banking Committee, though, for 8 years, and what I saw starting in 1969 when I went on the committee was that each of the financial institutions—banks, savings and loans, and credit unions—attempted to gain a legislative advantage for themselves that some of the powers at the other financial institution had, without any of the liabilities of the other financial institution. And I advised them at the time that if they started that—I mean, the savings and loans wanted regulation-Q and at the same time the power to have negotiated orders of withdrawal, i.e., checking accounts—that if they all started that, you were going to go down the road toward fungibility, and you would all look the same and would eventually all be taxed the same. And I'm not sure I like that. I like the idea that the credit unions once served relatively small owners of businesses and small individuals, and that savings and loans served principally homes, and banks made loans on cars. But those days are gone, I think, and sometimes it seems difficult in my mind any longer to be able to tell the difference between a large credit union and a small savings and loan or a small bank.

Mr. Olson, let me ask you: How does the American Banking Association feel about taxing large credit unions?

Mr. OLSON. Mr. Chairman, just referring back to a comment that you just made, we have always favored in general the policy that financial institutions that perform identical services ought to have a similar treatment with respect to their regulation and their tax treatment. Beyond that, we are not prepared today to talk about the specific proposal in this bill with respect to credit unions.

The CHAIRMAN. But you are saying equal financial institutions ought to be taxed equally if they perform roughly equal services?

Mr. OLSON. That has been our position.

The CHAIRMAN. All right.

Now, in your testimony you alluded to the fact that you think your deposits with the Federal Deposit Insurance Corporation sort of ought to be counted as "taxes."

Mr. OLSON. Well, they are certainly a part of the cost of our doing business with the Federal Government. To put it in bankers terms, if you were a corporate treasurer of a corporation, and you were doing your banking business with a major bank, you would be obligated to provide a compensating balance which would be included and quickly identified as the price of doing business. And your cost of doing business would then exceed the interest rate, and it would be calculated on a yield basis. That is instantly understood as part of the cost of doing business.

When we keep idle reserves with the Fed, we instantly recognize that as a part of the cost of our being in business. Mind you, we don't quarrel with that. As a matter of fact, back in the Monetary Control Act, we favored increasing those reserves; but it is indeed part of our contribution.

Now, beyond keeping those reserves, we are still charged specifically and explicitly for the services that we receive either from the Fed or from the regulatory agencies.

The CHAIRMAN. Senator Durenberger.

Senator DURENBERGER. Thank you very much, Mr. Chairman. I am sorry I was late, but, as you know, I was on the way back from the CIA.

I want to welcome the two Minnesotans that we have anchoring each end of the table here today, and I would like to introduce into the record an article in last week's St. Paul Sunday paper which said that the president of the First Security Bank of Fergus Falls said we ought to have a level playing field, and that the director or executive director—whatever Joe's title is—president of the Minneapolis Federal Employees Credit Union will say there are reasons why the playing field is slightly unlevel. I am very proud of both of these gentlemen. Joe has not only been president of the Minneapolis Federal Employees Credit Union but of the Minnesota League of Credit Unions and a number of organizations, and I can see why he is here today. Mark Olson taught Bill Frenzel everything he knows about everything over on the House side and has now been selected to be president-elect of the ABA.

I have a question, though, of Mr. Caspersen.

I heard at the end of your testimony, Mr. Caspersen, that this is a great chance to rid ourselves of an unfair tax system, that what is good for the consumer is good for business—that is what I heard you say. So I rushed to your statement, which says that "most of our customers will pay less taxes and therefore have more disposable income to save, to spend, or invest. As Americans become financially healthier, they will be better customers for our services."

You go on to say that "it is important than when the dust settles the average American must feel that he is better off as a result of these changes, and specifically that his tax burden has been reduced."

And in a vacuum I find it difficult, at least as I was growing up in this country, to disagree with that kind of a statement. But today you and I both and all these average Americans are presented with a situation in which Federal spending on behalf of all average Americans is $967 billion; the individual income tax, which you want to have reduced or the burden of that tax reduced on the average American, this year will raise one-third of that amount, about $331 billion. The corporate income tax will raise, at a max, $58 billion; last year it raised $36-38 billion towards that goal of a $967 billion spending. And since we have to balance both of these equities, and since I am really interested in your view of fairness in the overall sense, in your view of the American public's view of fairness, my question is: How low—this goes to another thing in here someplace—how low must the income tax rates be in America to satisfy the American public and the businesses like your own which live off the consumption of the American public? How low do we have to get those rates?

Mr. **Caspersen**. My answer would be, Senator, not "how low" but "how level". We have to have a broadbased tax that covers all areas, that it is not a question of driving down rates. That is very helpful, but it is a question of broadness, of perceived broadness.

Senator **Durenberger**. Is there anything wrong with a 50-percent top rate on the individual income tax in America, in your view?

Mr. **Caspersen**. From my view, I would rather see a top rate akin to the President's plan, although there is nothing magic in that rate I might add, that was broad, that didn't depend on what business you were in, it didn't depend on how able your tax attorney was, it didn't depend on how numerous your tax shelters were.

Senator **Durenberger**. But do you have an opinion in terms of how much money people need to have left over after taxes to do other things? How low must that rate be in America against what people are getting in the way of services in this country? Is 50 percent too high, too low?

Mr. **Caspersen**. I think 50 percent is too high. I would rather see it down in the 30's as a max rate. It may not be able to get there; that is a revenue question.

My argument today is broadness, levelness, with no exceptions. Let us put us all on the same playing field; let's look into and understand that we cannot have all these different rules that were put in here and there, all for good social purposes; but things have changed. Let's broaden it; let's go level; and let's put everybody on the same field, and not too many hills.

The **Chairman**. Senator Grassley.

Senator **Grassley**. Mr. Caspersen, I would like you to comment on the issues of interest deductibility and personal residences. Of course I favor the interest deduction on a principal residence; but do you feel there is going to be and do you foresee an increase in first, second and third mortgages on principal residences as the result of the restriction, the overall restriction, on interest?

Mr. **Caspersen**. There has been over the last decade a tremendous increase in second mortgages. There has not been, except in certain speculative areas, or certain areas, increases in third mortgages, to my knowledge. The reason for this is the growth in the home equity, occasioned by two things: one, the inflationary times we have gone through and, two, the payment of the principal mortgage.

As the cost of the principal mortgage has gone up over the last decade, it has become more economic to take out the incremental equity via a second mortgage. I believe these trends will continue. I think this bill recognizes it, and because of that treats all mortgages equally on the principal residence.

Senator GRASSLEY. Mr. Perkowski, I have a question for you that is more in the way of being the devil's advocate, as opposed to any disagreement with anything you have said. But before I ask that question I would make an observation for the benefit of my colleagues. In the years I have been in Congress both on this committee—and also in the 4 years I served on the House Banking Committee—I note that in relationship to this tax bill, the absence of either the bankers, or the savings and loans lobbying for the taxation of credit unions the fact that neither the national organizations nor their state affiliates in my state are advocating these changes is some recognition of the unique role that credit unions serve. I don't see your competition out there, who would normally be talking about a level playing field, trying to level that playing field by taxing you. At this point, I only see that coming from the Treasury Department.

Now, the question. You said that credit unions' exemption from the federal taxes is justified because you have had it that way for 48 years. And of course the argument is, the benefits go to the members, and that taxation would undo those benefits. How consistent, though, from your point of view, is this rationale with the goal of the level playing field?

Mr. PERKOWSKI. Senator, let me respond by first saying, if we were to take the assets of the credit unions, the banks, the savings and loans and the thrifts, the credit unions make up 4.8 percent of that market. So, it isn't like we are running away with market share and impacting all the other financial institutions.

I think, as to the level playing field, what we would do if we were taxed, we would unlevel the playing field for our 52 million members. They are the benefactors of our services and products, and the credit union is just an extension to provide them.

There isn't a level playing field. Just by taxing us doesn't all of a sudden make us level with the other financial institutions. We don't have any holding company laws; we could only serve our fields of membership; we don't make commercial loans; and there is a long litany of services that credit unions do not perform and, by the way, we do not want to perform. We want to do the job we do best, and that is serving our consumer member.

Senator GRASSLEY. Mr. Chairman, that is my last question.

The CHAIRMAN. Senator Baucus.

Senator BAUCUS. Thank you, Mr. Chairman.

Gentlemen, most commentators on the American economy today believe our savings rate is too low. I have several questions to ask you. The first is, do you agree that the U.S. personal savings rate should be increased significantly, or that public policy should push in that direction?

Second, if you do agree, I would like to ask you how you propose we do that.

Third, please comment specifically on the advisability of limiting deductions of consumer interest expenses, and of increasing downpayment requirements.

Mr. MORRIS. I might to respond to that, Senator.

First, we certainly do feel that savings rates are too low in this country, when you compare rates in the first country that pops into mind, Japan. There are some cultural difference there, but basically I think one of the things that probably causes our savings rate to be too low is our tax system right now. The tax system virtually creates no incentive for savings. Our system, in my mind, is completely reversed: we actually extend to the person borrowing money the benefit that I think ought to go to the person who is putting money aside in savings, providing capital for this country to grow on.

Senator BAUCUS. Do all the rest of you generally agree that our savings rate should be significantly increased? Would anybody disagree with that?

Mr. OLSON. Senator, with respect to that question, are you talking about the percent of a person's income that is devoted to savings as opposed to consumption?

Senator BAUCUS. Right.

Mr. OLSON. We would generally support what was said, also. I think in terms of our perspective, we have seen a change in the mentality of our customers, where certainly in the late seventies and the early eighties there was very much of an inflation mentality, and the assumption was that it was important to purchase things as opposed to savings, because there was no way to beat the rate of inflation.

Senator BAUCUS. I would like to ask each of you to list one, two, or three ways—in order of priority—we could most specifically accomplish that goal. Not generally, but specifically, what changes in the Tax Code would you advocate?

Mr. OLSON. Reduce marginal rates of taxation.

Senator BAUCUS. Reduce marginal rates. Anything else.?

Mr. OLSON. That would be the priority.

Mr. MORRIS. I would like to comment that there are a couple of provisions in this Treasury proposal that need to be looked at:

One, we certainly support the increase in the IRA, the Spousal IRA; but we also support the Treasury proposal that came out in May that did not repeal the 401(k) section. We think section 401(k) provides an important avenue, a piece of the puzzle, to increasing that core of savings.

The CHAIRMAN. Max, may I ask a question to make sure that they understand what you are asking?

You are not talking about shifting savings; you are talking about——

Senator BAUCUS. New savings. That is the key problem: how do we address the shifting of existing saving. Some claim that IRA's have basically created a shift of savings, not new savings.

Mr. CANNON. I would just like to comment briefly on that. I think that the proposal that Mr. Morris talks about, increasing the Spousal IRA, would not tend to do that. In our judgment it would tend to be new money, fresh money, as opposed to just shifting, say, the husband's IRA account or money over into the wife's account.

Senator BAUCUS. Let me ask the question more specifically.

Senator BRADLEY. What is the evidence of that?

Senator BAUCUS. Excuse me just a minute, Bill.

The next question I want to ask is, how much should we increase personal savings? The current estimates of the share of personal income saved in America today is about 5 percent. It is closer to 20 percent in Japan. What should the personal savings rate be? How much of a family's or a person's income should be saved? What should the goal be, do you think?

Mr. MORRIS. I don't know what the goal should be, but the latest figure I think was 2.8 percent, the lowest it has been in decades. So it is going the wrong way.

Senator BAUCUS. What should the goal be? Should it be 10 percent? Fifteen percent? What do you think it should it be?

Mr. MORRIS. You could almost just pick a number. Anything is better than where we are now. Ten percent would look awfully good.

Senator BAUCUS. One more quick question, if I might, Mr. Chairman.

What about limiting the deductibility of consumer interest expenses? Isn't complete deductibility a real problem in this country?

Mr. CASPERSEN. I would take issue with that. I think, one, this bill does for the first time limit that deductibility in a very major way, and indeed we are seeing some of the reactions and I am certain you have heard some of them in this committee.

Second, there is a real question on what savings are and how one should incentivize it. It is an incredibly complex and incredibly culturally oriented question. We have sponsored several major forums with Wharton on savings, and hopefully they will come back this fall with some specific recommendations on this subject. But it is a culturally oriented question.

Mr. MORRIS. I think we would like to see the Tax Code oriented toward an incentive for savings, and we feel one way to do that is to take the incentive away from borrowing to consume.

Senator BAUCUS. Thank you.

The CHAIRMAN. Senator Bentsen.

Senator BENTSEN. Mr. Caspersen, I read with interest your statement, and it is a very statesmanlike statement, but let me question something about your own company. I was surprised to see you say that the bill increased your taxes by $100 million. I would have thought that a service business such as yours, without great capital outlays for depreciable equipment—I know you must have a great amount of depreciable equipment, but I'm referring to major plants and that type of thing—would not have had an increase in taxes. Explain it to me. Why do you?

Mr. CASPERSEN. Senator, my job as chairman is to maximize the profitability of the corporation. As such, I look at the Code that this body has passed, and I see opportunities to minimize taxes, and frankly we have taken those. We have gone out of our core business, we have done things such as lease airplanes, et cetera, leveraged leases, depreciation, we have utilized all of the opportunities that the Code has allowed us.

Senator BENTSEN. I see.

Mr. CASPERSEN. And my argument today is that our expertise is in consumer financial services. We would rather concentrate on that. We think we could do more for the economy by pursuing that. And we should take away the incentives that make us interested in satellite leasing, and instead concentrate on the consumer.

Senator BENTSEN. I can understand, now, how you arrived at that.

Let me speak to the banking association representative because I have some sympathy with the one point in particular about loan reserve losses.

I have been one on this committee who has worked to try to slow down the decrease in the deduction that is allowable for that. Where the Treasury was trying to use just the experience ratio I said that just to extrapolate experience into the future is not a true indicator of where the economy is going. And unfortunately, I have been proven right on that.

But my concern is, at a time when they are talking to banks about raising capital, when they are talking about putting a risk ratio in on FDIC, isn't this bill counterproductive?

Mr. OLSON. You are exactly right. And your recollection of the history is also correct. Most banks, I think, now are on the experience-basis, because that is the only option available to them.

We are very concerned about the impact that a change in that provision would bring. The banking industry, and particularly in the ag areas, and I am sure in your case in the oil areas, where banks are wondering whether or not we have seen the bottom of the economic crisis in our various parts of the country, the banks are reserving.

Senator BENTSEN. Well, I think that is agriculture, real estate, and oil service businesses, all of those. You are going to see some tremendous losses taken.

Mr. OLSON. Exactly. And banks are reserving very aggressively in anticipation of what the problems might be. Many of the banks do not have ready access to capital. If we were to certainly tax the reserves that have been built, and then in addition change the manner in which we can allow for loan losses for tax purposes, I think that would have a very dramatic impact on the banking industry.

Senator BENTSEN. Well now, I don't want you to get by scot-free and think that I agree with you on everything; I want you to explain to me why a sophisticated institution like a financial institution can't go to accrual accounting. I notice you oppose that provision.

Mr. OLSON. That for tax purposes we would not go back to accrual accounting? For tax purposes?

Senator BENTSEN. Yes.

Mr. OLSON. I think that the principal reason for that is—I had better turn that over to Mr. Gordon Martin. [Laughter.]

Senator DURENBERGER. I told you that kid was smart. [Laughter.]

Senator BENTSEN. I may have found the soft underbelly. [Laughter.]

Mr. MARTIN. Let me just say that the present code, as it is presently drawn, offers sufficient ability to the IRS to monitor and to prohibit or to stop any abuses that would come about through the cash-accounting method. So, while it may in some people's minds be theoretically a purer way to go, it is not something that can't be controlled through the present system of cash accounting. So I think cash accounting is an appropriate device that has been used for many years and is well controllable under the present system.

Senator BENTSEN. You all may have to work on that answer.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Long.

Senator LONG. No questions, Mr. Chairman.

The CHAIRMAN. Senator Bradley.

Senator BRADLEY. Thank you very much, Mr. Chairman.

Let me welcome Mr. Caspersen to the committee and thank him very much for his testimony. I was interested in everyone's testimony, and I am not just interested in Mr. Caspersen because he is from New Jersey, but I am interested in it because of what he had to say.

A hundred million dollar tax increase for your company, and you are for tax reform? And you say the reason is——

Mr. CASPERSEN. The reason is, very simply, in our evaluation we are going to make more money over that 5-year period from the increased prosperity of the middle-class consumer whom we serve.

Senator BRADLEY. That is a very powerful vote of confidence in the long-term effect of major tax reform, and I think it is a significant statement.

Senator Durenberger tried to get you to say what you thought the individual rates should be, and in the course of his question he talked about the individual income tax now raising about $335 to $340 billion and the corporate tax about $58 billion, so that the total raised from the income tax, corporate and individual, is about $400 billion. This year the value of all the tax expenditures will be $400 billion. So, we lose as much as we get by the way we have designed the Tax Code. What does that tell you?

Mr. CASPERSEN. Well, it tells me that the perception of the average American is absolutely accurate: that the code is not fair.

Senator BRADLEY. That the $400 billion that is raised is raised from those who haven't figured out a way how to use the other $400 billion, right?

Mr. CASPERSEN. Usually because they just do not have access to the proper tax advice.

Senator BRADLEY. I heard you talking about how you thought this would be good for everybody, and the unfairness that you perceived in the code. It sounded to me like it boiled down to the conclusion that the problem with the present code is that equal incomes just don't pay equal tax. Is that right?

Mr. CASPERSEN. Exactly.

Senator BRADLEY. We have a number of proposals before us, and in the administration bill one of those proposals is that you can deduct the mortgage interest on your principal residence but not a secondary residence.

Now, since you are all innovative lenders, what might you do for your customer with a second home to ensure that he does not lose any tax advantage from this particular proposal in the code? Can you, off the top of your head, think of any way? [Laughter.]

Because I have a couple of suggestions that I would like to run by you.

Mr. Morris. Senator, I might respond that as innovative as you say we are, we are not nearly as innovative as our customers; and I think the obvious thing is that customers are coming in saying, "Will you put a second on the equity I have in my home so I can take that money to buy a second home?" or whatever. I don't think it is necessarily the innovativeness of the lender; the customer is pretty smart.

Mr. Olson. Senator, I may also say that we, like a lot of institutions that have been heavily involved in real estate, have a fair number of 8, 9, 9.5 percent loans, and our innovation would probably ask us to rewrite the principal home, on their residence, to do that. But as has been indicated, the consumer has already figured that out before we did.

Senator Bentsen. Senator Bradley, I think your constituent has about as many second mortgages as anybody in the country.

Senator Bradley. Well, that's one of the reasons I asked the question.

So, if we are really interested in equal incomes paying equal taxes, and we want to try to even out the mortgage interest, maybe we are not going to be able to do that if we simply say "primary but not second or third homes," right?

Mr. Olson. There is another concern that we have, too.

Senator Bradley. Well, just yes or no.

Mr. Olson. Yes.

Senator Bradley. I see my time is running, that's why I want to get into more questions.

Let me just ask Mr. Morris a question. You said that savings rates are down to 2.5 percent, and that troubles you. That is the lowest I have heard in a long while. If that is so, after the expansion of the IRA, after the tax-exempt status for credit unions, after this savings vehicle and that savings vehicle, why, then, is the present system not working? And why would you expect that increasing the IRA would increase savings?

Mr. Morris. I don't think there is any one item—401(k) or IRA or whatever—that is going to solve that total problem. As was mentioned, we have some things in our culture—Social Security, the retirement pension programs—that all stop or slow down a person's desire to save out of his disposable income. Any piece in the puzzle that would encourage additional money to be set aside will help that program. I don't think there is any one thing that is going to solve that total problem.

Senator Bradley. So, because there is a subsidy to borrowing, you have to overcome that subsidy to borrowing by offering a subsidy to savings, or remove the subsidy to borrowing, right?

Mr. Morris. Yes.

The Chairman. Senator Chafee.

Senator Chafee. Thank you, Mr. Chairman.

I have just a question of Mr. Caspersen. On page 4 of his statement—and this may have been covered; I came late.

You say that Beneficial, like many other companies, structured its financial affairs and made investments over the past several years "for the specific purpose of minimizing its corporate income tax burden. It would probably no longer be prudent or economically viable to make such investments if the tax reform proposals are adopted in their present form."

My question to you is, what possible changes would you make in your portfolio? What would be the direction of those changes? I am not saying specific securities, but I mean what direction are you talking about? What might be the consequences of that change in your investment portfolio, which presumably would be duplicated by many other companies in your industry?

Mr. CASPERSEN. Well, let's take a specific example. In the last several years we have been active in the leverage leasing market, and specifically have taken interest in several—several dozen to be accurate—727's. That allows us ITC, it allows us depreciation, it basically covers and shelters a certain amount of income. That is not our area of expertise, but we look at that, and we look at the after-tax return; in other words, all the return, which includes tax savings and interest on our position. And if we see that is greater than say 15 percent, if we are using a 15-percent benchmark, say, 18 percent, then we will allocate money there. Well, the real return is much lower if you disregard taxes. We would get out of that business completely and allocate the funds instead to our core business, consumer financial services.

Senator CHAFEE. I just wonder, everything has a ripple effect, obviously, and so then Boeing's worried about how their customers are going to get financing to purchase Boeing aircrafts, 747 or whatever. I suppose that gap will be filled somewhere.

Mr. CASPERSEN. It will be filled on the basis of the real return, and not on the U.S. Government-assisted return.

Senator CHAFEE. I see.

All right. That is the only question I had Mr. Chairman.

Thank you.

The CHAIRMAN. Mr. Morris and Mr. Cannon, should banks be able to deduct foreign taxes paid, the way other businesses do?

Mr. CANNON. Mr. Chairman, I don't feel qualified to respond to that.

The CHAIRMAN. Mr. Morris.

Mr. MORRIS. Senator, I would say that the objective of this bill is to promote fairness, as Mr. Caspersen has said, and I think anything in the tax bill that would promote fairness, this committee and the Ways and Means Committee should take a look at.

The CHAIRMAN. What does that mean in terms of an answer to my question? [Laughter]

Mr. MORRIS. It is an evasion. [Laughter]

I am really not that familiar with the foreign-source income from the banks to make a comment.

The CHAIRMAN. This isn't foreign-source income. These are taxes they pay overseas, just like any other American company that happens to be overseas, and you get to deduct them so they don't have to pay double taxation, in terms of figuring your taxes. I was wondering if banks—they are allowed to do it now—should continue to be allowed to do it.

Mr. MORRIS. I assume so.

The CHAIRMAN. Now, we may want to change it for all companies. In fact, there is a provision in here to limit it on what the banks know as a per-country limitation. But that is not just for banks, that is for everybody.

The reason I ask this question: I think it is a cheap shot on occasion when people talk about the low effective rate of taxation of banks, and they do not take into account the foreign taxes paid in an attempt to give a misimpression as to how much banks pay in the way of taxes.

I am well aware that savings and loans, unless I am mistaken, do not operate overseas very much.

Mr. MORRIS. That is correct.

The CHAIRMAN. Banks do. And I just think it is a cheap shot if on occasion people make references to their low tax rates and do not take that into account.

Let me ask one last question, generically.

During the fifties and sixties, up until about 1973, the savings rate in this country bounced around between 6.5 and roughly about 8.2 percent. It reached a high, as a matter of fact, of 8.2 or 8.3 in 1972, 1973, 1974. But all during the fifties and sixties when we were expanding tremendously, real growth in this country, we did it with about a 7-percent savings rate. Why were we so effective at the expansion in those days with a relatively low savings rate? Because people point at Japan at 18 or 20 percent and Europe at 12 or 13 or 14 percent. Why were we successful then at real growth in this economy with a relatively low savings rate?

I will start with Mr. Olson.

Mr. OLSON. I don't have the figures in front of me, Mr. Chairman, but it is the real rate of savings that is the key factor. When the savings rate relative to the inflation rate was such that the consumer actually could find the advantage in saving, that is when savings accumulated. And I think when that rate was overtaken by the rate of inflation was when we saw the rate of savings decline.

The CHAIRMAN. Oh, I understand when it went down. I want to know why this country was able to expand so much in the fifties and sixties with a relatively low rate of savings.

Mr. OLSON. Again, the real rate that they were earning relative to inflation was so much better.

The CHAIRMAN. I understand your answer. I am not sure that answers the question, but I will leave it there.

Go ahead.

Mr. CASPERSEN. I think it is a very complex question. In the fifties and sixties you really had the benefit of an industrial plant, and a country that had not moved forward partially because of the Depression and partially because of World War II. And all of a sudden, you had this huge pentup demand. There is that, and there are a tremendous amount of other factors. I think it is an incredibly valid question, because if you find the answer to that, then you can apply that in learning where we are now. But I think the answer is going to be very complex.

Mr. MORRIS. I would like to make a comment strictly from a layman's point of view and not because I have done any studies or am an economist. It seems to me that one big difference between the fifties and now is the Federal deficit. At that time the deficit was relatively low compared to what we have right now, and that deficit is taking up more and more of those dollars, those savings dollars that are put aside, and running them back through the Government; whereas, in the fifties it seemed to me that there were enough dollars left to provide the capital for this country to grow on.

The CHAIRMAN. Mr. Cannon.

Mr. CANNON. I think that I would agree with that conclusion, whether I am an economist or not. The budget is much, much higher in terms of money being utilized by our government today, and just to service the debt of that deficit takes a lot of money, potentially, out of the savings market.

The CHAIRMAN. Mr. Perkowski.

Mr. PERKOWSKI. I couldn't add anything.

The CHAIRMAN. Senator Durenberger.

Senator DURENBERGER. I don't know if I can add anything with a question, either. But I wonder if we weren't getting close to it when we talked about debt service and its impact on whatever current earnings we have, whether we have government or industry.

I would like to ask all of you a question that I asked Jim Baker about 6 months ago, and that is whether or not you believe that if you were on the Senate Finance Committee, having to make a decision about what the U.S. income tax ought to do to the income of Americans, the question is what set of principles would you use to guide you? Or, first, would you even want to set a principle? Or should you just sit there and react to other people's recommendations, sort of an incremental reaction:

> This thing is so bad that, having identified the badness in it, that is, unfairness, then we would just take out the unfair part of it. Or would you like some other set of principles?

I asked Jim this question, and he said, "Well, the principles are very simple: a maximum rate of 35 percent and 33 percent," which is why I asked the earlier question. "The second principle is revenue neutrality. The third principle is the poor should not be be taxed." The fourth principle was families should be, somehow, protected.

Well, we burst into a disagreement over what families are. There is some question of how to tax or not tax the poor. But it is clear that 35 to 33 percent and revenue-neutrality are the guiding principles.

Now, there is another set of principles that I would offer to you that I think relate more to a tax on income. For example, I use my income to satisfy certain important personal needs of me and my family, whether I am poor, middle income, or rich: my home, my health, my education. I have to divert a portion of my income to those purposes. And traditionally in America we have used the Tax Code to facilitate that in some way. I ask you if that is an important principle.

Second, and related to it is: I purchase some income security with that, in some fashion; against my disability or that of my family, against my retirement or the widowhood of my wife, or whatever the case may be.

The third thing I do is, I invest in other people so that they may create job opportunities in a productive society—capital investment. That seems to me to be a relatively important principle in an income Tax Code; forget all the other taxes.

The fourth is consumption. If you want everybody to consume like mad, you can set things up like we have in this country over the last 30 years, that you are all experts on: that is, the interest deduction. Anything you want to buy, you borrow, and somebody else pays for it. You can consume like mad in this country, if that is what you want to do. Or, you don't want to do.

Now, I give you those four as a suggested alternative set of principles, and just ask you if I am way off base in suggesting, that lightening the burden, making sense out of the income tax, and fairness, are a better set of principles to guide us than the rate and revenue-neutrality.

Mr. **Olson**. Senator, the ABA's economic advisory group, made up of economists from a number of the banks, established a broad-based set of criteria to be used when considering tax law changes. This criteria was adopted prior to the time that they were looking at the specifics of this proposal or any other proposal, but it is four relatively broadbased principles.

No. 1, reduce rates; No. 2, broaden the base; No. 3, remove taxes from investment decisions, which I think in your case was what you were referring to in some of your specifics; and No. 4, promote fairness. So, within that broad context, which includes a lot of what you are saying, those are the principles that we would recommend.

Senator **Durenberger**. Mr. Caspersen.

Mr. **Caspersen**. I would particularly emphasize the reduction of the rates. I think it is absolutely essential to maximize productivity in this country, for many, many reasons, which need not be gone into here. And in order to do that, we have got to take out tax decisions from productivity decisions.

Senator **Durenberger**. Mr. Morris.

Mr. **Morris**. I think two things: One, the deficit is so much on our minds that I think we have to look, when we are looking at the Tax Code, at what the Government is spending. Spending has to be reduced; the Government has to be responsible. I think we have to meet, as you suggest, the basic needs of the family in the Tax Code. And I think we have to encourage savings rather than encourage consumption.

Senator **Durenberger**. Mr. Cannon.

Mr. **Cannon**. Senator, I would agree with everything that has been said so far, and would add to that. I think that tax decisions in this committee or other bodies in the other house should not be made in a vacuum. I think other members, representatives of business and people, should have their input on the impact on various institutions that are involved here, and make a determination about whether or not you want those institutions to continue doing the job that they have been doing. And if you do, if you say yes to that, then the tax policy I think should not guide that, should not interfere with that.

Senator DURENBERGER. Joe.

Mr. PERKOWSKI. Senator, we are not economists; we just run a credit union. However, in our testimony we did mention that one of the things that helps us in serving our members is that we do not have to make decisions based on a Tax Code; we make decisions strictly based on our members' needs. And I think what you are suggesting would possibly make that possible for others as well, and I would subscribe to it.

Senator DURENBERGER. Thank you.

The CHAIRMAN. Senator Long.

Senator LONG. No questions, Mr. Chairman.

The CHAIRMAN. Senator Baucus.

Senator BAUCUS. In 1981 when we lowered marginal rates, out personal savings rates did not increase. Why will further marginal rate reduction increase personal savings, you have advocated, Mr. Olson?

Mr. OLSON. I think in 1981 we were just coming out of the high interest rate environment, and we still had not——

Senator BAUCUS. Why won't people just spend the additional money that they have in their pockets? It won't be very much anyway, but why won't they just spend it? Why will they save it?

Mr. OLSON. In my judgment there is a shift in the mentality, where people now believe that they can save and that it will be economically beneficial to them. And I don't think that was the case in 1981.

Senator BAUCUS. What is the evidence of that when as personal tax rates went down, personal savings rates also went down?

Mr. CANNON. Senator, a part of the response would be to take a look at what happened after the creation of the authority for universal IRA's. Prior to that time, I am sure you recall, IRA accounts were only available to those individuals that did not have a sponsored pension plan. But once they were made available to everybody, including those people, we have had tremendous increases in those accounts. That represents a great increase in savings.

So, I am talking incentives rather than, I suppose, tax credits which can be spent.

Senator BAUCUS. Well, I am still not convinced that lower marginal rates are going to necessarily result in significantly increased personal savings rates.

Mr. CASPERSEN. I think one of the things that you have to consider here, too, if we are going to talk about savings in depth, is the accuracy of the figures that are being presented to you. As I understand the figures, they do not include in savings increasing values in the home ownership area.

The home is the average American's largest single savings vehicle. I think we all agree with that. And, given that, any accurate portrayal of savings rates has got to include values in homes.

Senator BAUCUS. Where does the value of the farmhouse figure in there?

Mr. CASPERSEN. That is an entirely different problem. But there really is a problem on this, on the savings. We talked briefly about second mortgages earlier. Second mortgages are not borrowings;

they are the releasing of savings, liquifying houses. People, rather than refinance the first, in effect use a second. They take the second out and liquify their equity in their homes.

Mr. MORRIS. Senator, the U.S. League has done a study on that, and I believe we can supply you with the results of that study. It indicates, in normal situations, not in a recessionary period such as we were in in 1981–82, that an increase in disposable income will increase the savings.

With your permission, we would send that to you.

Senator BAUCUS. I would like to see that study. Intuitively, I just don't believe it given historical rates. I think it is more of a cultural phenomenon; a great many factors bear upon it. And tax incentives or disincentives are just one of many factors—even if a significant factor. Some of it is work ethic; some is expectations of the future, et cetera. But we have to work at it with lots of different approaches, lots of different directions.

Mr. MORRIS. There is one other phenomenon that we are going through right now. For want of a better term it is called the life cycle of savings. With just the demographics in this country right now, we have a bigger majority of people in the spending age, say the 25- to 45-group. When people are 45 and older is when they tend to start saving, and right now the bulk of the people for the rest of this decade are going to be in the 25- to 45-nonsaving age category. That is another factor.

Senator BAUCUS. Thank you.

[The U.S. League's study follows:]

U.S. LEAGUE OF SAVINGS INSTITUTIONS
COMMITTEE ON ECONOMIC AFFAIRS

PERSONAL SAVING IN THE UNITED STATES

STAFF PAPER 5

James W. Christian
Senior Vice President and Chief Economist

and

Mark W. Baumann
Associate Economist

July 1985

Copyright: U.S. League of Savings-Institutions, 111 East Wacker Drive, Chicago, Illinois 60601

TABLE OF CONTENTS

INTRODUCTION

CONCEPTS OF SAVING

PERSONAL SAVING IN CONTEXT

THE DETERMINANTS OF PERSONAL SAVING

- Basic Motives for Saving
- Population Demographics
- Income Security Programs
- Availability of Credit
- Inflation
- Tax Treatment
- Uncertainty
- Interest Rate Movements and Wealth Effects

THE PERSONAL SAVING EQUATION

CONCLUSIONS

INTRODUCTION

That Americans save too little is scarcely in dispute. No concensus exists, however, regarding the policy measures that should be taken to remedy this situation.

In part, this lack of concensus results from different concepts of saving and different ways of measuring saving. These differences are readily explained on technical grounds alone. A much more important source of confusion results from the fact that most analysts, commentators and policy makers identify personal saving with decisions made by individuals. In fact, the vast majority of personal saving today is done by employers through pension fund contributions; discretionary personal saving--the saving that results from a conscious decision by individuals and households to postpone consumption--has been trending downward since the mid-1970s, in both relative and absolute terms.

This particular facet of personal saving behavior in America today has profound public policy implications. Most of the analysis of our "low" personal saving rate has focused on the use of tax incentives to increase personal saving. Yet pension fund contributions and earnings are already tax-deferred, so that tax incentives for saving can affect only the much smaller portion of total personal saving represented by discretionary personal saving. Tax incentives for saving are therefore likely to be perceived as ineffective when measured by the increase in total personal saving, including pension contributions and earnings.

Indeed, some measures that incur no tax revenue losses might prove to be as effective as measures that do.

The purposes of this paper are to examine the influences that have contributed to "low" personal saving rates in this country and, in so doing, to provide the basis for alternative policy measures designed to increase personal saving.

CONCEPTS OF SAVING:

Ask an individual to define his savings and he is most likely to talk about his balances at depository institutions and his holdings of stocks and bonds. If pressed, he may include the equity in his home, the value of other tangible assets--his wife's jewelry, his car or his boat--and perhaps the cash value of his life insurance and pension plans. If asked about his saving behavior, he is most likely to talk in terms of additions to his deposit balances, his purchases of stocks and bonds and, perhaps, the appreciation in value of his tangible assets. He is, however, unlikely to refer to changes in his outstanding debt, except perhaps with regard to the equity in his home. Individuals thus have a relatively firm grasp of saving in terms of gross assets (both tangible and financial) and a much weaker grasp of the concept in terms of net worth or changes in net worth.

Ask an economist to define personal saving and he will speak in terms of the difference between disposable income and consumption expenditures. In this sense, personal saving is taken as an aggregate concept that nets out the additions to debt used to finance consumption expenditures. The economist thinks of saving in terms of the economic resources left over after consumption decisions have been made; these resources are then available for investment purposes. Thus, even though one individual does not spend all that he earns and "saves" some portion of his income, that portion cannot be considered as saving for the economy if another individual borrows those funds and uses them to consume more than he earns. Assuming that one individual's debt-financed consumption in excess of his income was in exactly the same amount as another's saving, the combined income statements of the two individuals would show no saving whatsoever.

This use of the same word to refer to different concepts causes more than a little confusion in the debate over the adequacy of the personal saving rate in the United States when that debate is carried beyond the small circle of professional economists to the broader arena of the public at large. While it is easy enough to use any of these concepts to support a policy of, say, tax incentives for saving (or disincentives to consumption or borrowing), it is another matter to know how to structure such incentives to achieve more specific objectives than simply broadening and deepening the pool of saving. The understanding necessary to shape a policy to such ends requires a deeper understanding of the linkages between the different variables and of the behavior of personal saving.

PERSONAL SAVING IN CONTEXT:

Personal saving, by the economist's definition, is but one of five types of saving that make up the total pool of economic resources available for investment. The other four types of saving are: the retained earnings of business (net business saving), the budget surplus of state and local governments, the budget surplus of the federal government and the net saving of foreigners invested in the United States. Table 1 shows the relative composition of these various types of saving.

Table 1

Components of Total Saving
(Billions of Dollars)

Year	Personal Saving	Business Saving	Net Foreign Saving	State & Local Govt Saving	Federal Govt Saving	Total Saving
1960	$ 19.7	$ 12.1	$ 2.8	$ 0.1	$ 3.0	$ 37.7
1961	23.0	12.4	- 3.8	- 0.4	- 3.9	27.3
1962	23.3	18.2	- 3.4	0.5	- 4.2	34.4
1963	21.9	20.4	- 4.4	0.5	0.3	38.7
1964	29.6	23.9	- 6.8	1.0	- 3.3	44.4
1965	33.7	30.0	- 5.4	0.0	0.5	58.8
1966	36.0	32.0	- 3.1	0.5	- 1.8	63.6
1967	44.3	29.7	- 2.6	- 1.1	- 13.2	57.1
1968	42.0	28.0	- 0.6	0.1	- 6.1	63.4
1969	40.6	23.1	- 0.4	1.5	8.4	73.2
1970	55.8	14.8	- 3.2	1.9	- 12.4	56.9
1971	60.7	22.8	0.8	2.6	- 22.0	64.9
1972	52.6	30.6	5.1	13.5	- 16.8	85.0
1973	79.0	32.3	- 6.5	13.4	- 5.6	112.6
1974	85.2	13.4	- 2.9	6.8	- 11.5	91.0
1975	94.3	29.1	- 18.3	5.5	- 69.3	41.3
1976	82.5	36.9	- 5.1	16.6	- 53.1	77.8
1977	78.0	53.7	13.7	28.1	- 45.9	127.6
1978	89.4	62.2	14.3	30.3	- 29.5	166.7
1979	96.7	54.5	1.8	30.4	- 16.1	167.3
1980	110.2	32.1	- 6.3	30.6	- 61.3	105.3
1981	137.4	42.3	- 5.8	37.6	- 64.3	147.2
1982	136.0	29.2	6.6	32.9	-148.2	56.5
1983	118.1	76.5	33.9	44.1	-178.2	94.4
1984	156.1	115.7	93.4	53.0	-175.9	242.3

Source: U.S. Department of Commerce, National Income and Product Accounts.

Several points are worth noting about the data shown in this table. First, it is clear that net foreign saving can be negative when Americans lend and invest more abroad than foreigners lend and invest in the U.S. Government saving can also be negative when budgets are in deficit. Conceptually, business saving and personal saving could also be negative under extreme circumstances.

Second, personal saving has traditionally been the largest single contributor to the savings pool, so that the emphasis that has been placed on personal saving is warranted.

Third, the negative saving, or dissaving, of the federal government has recently exceeded personal saving, leaving the private sector of the economy dependent, in effect, on other sources of domestic saving and on foreign saving.

Fourth, all of the data shown in the table are for net saving and are based on national income account definitions; thus, capital consumption allowances are not included in business saving (adding capital consumption allowances to retained earnings yields gross business saving).

Fifth, the federal budget deficits do not include all of the receipts and expenditures included in the Unified Budget and therefore appear to be smaller in the national income accounts than in federal budget presentations.

Sixth, net foreign saving has been negative in years past because, on balance, Americans invested more abroad than foreigners invested in this country. This situation has reversed in recent years because the U.S. has been running a huge foreign trade deficit, generating large dollar earnings for foreign producers; with U.S. interest rates at high levels relative to other countries and with the U.S. economy expanding more rapidly than other countries, it has been advantageous for foreigners to reinvest those dollar earnings in the U.S. rather than in their own or other countries.

The concern with personal saving in the 1970s was directly related to the larger concern over inflation. In an inflationary context, saving provides the funds necessary for investment in plant and equipment (as well as housing). Investment in plant and equipment encourages the growth of productivity and productivity growth allows wages and profits to grow without increases in prices. These relationships continue to hold, of course, but inflation has declined in the 1980s as a result of monetary restraint and generous tax incentives for investment. Consequently, the concern with personal saving has shifted.

Today, the concern arises from the precarious position in which the enormous federal deficits have placed the economy. Thus, while the tax incentives for investment put in place by the Economic Recovery Tax Act of 1981 may have encouraged a spate of productivity-enhancing investment, the failure to restrain federal spending has simply replaced the inflationary problem with a deficit problem. The inadequacy of domestic saving to finance the federal deficits and leave a balance available for private investment places the economy at the mercy of net foreign saving.

It is, of course, possible that the portion of the world capital market that is denominated in dollars has grown to such an extent that the U.S. may be able to count on a large foreign financial inflow for many years to come. Taken by itself, a reliance on foreign saving need not be viewed with alarm. If American consumers provide a market for foreign production, why shouldn't foreigners supply the saving needed to cover U.S. budget deficits and American investment?

There are at least two reasons for viewing this circumstance with concern, if not alarm. First, it is by no means certain that net foreign saving will continue. Were the United States in a position to compensate for a sharp decline in those inflows by either increasing its private saving or by reducing its public dissaving to compensate quickly for a decline in foreign saving, adverse consequences might be minimized. The federal budget deficits, however, are both very large and structural in nature. Federal spending simply cannot be reduced quickly because so much of it is dedicated to transfer payments rather than to purchases of goods and services. And even if the deficit were driven by goods and services expenditures, its size alone would cause economic dislocations if those expenditures were sharply reduced.

Second, the large foreign trade deficit that provides a basis for the foreign financial inflow is itself causing economic dislocations in the U.S. economy by wreaking havoc on our agricultural and manufacturing sectors. A continuation of these trends can therefore be expected to alter the fundamental structure of the U.S. economy in ways that are probably undesirable in the long-run.

The most straightforward solution to these problems is quite obviously to reduce the federal budget deficit to such an extent that the economy generates sufficient domestic saving to finance whatever budget deficit remains and still have resources left over to meet the needs of the private sector.

There are a variety of ways of reducing the federal deficit. The optimal means of doing so, however, is one that does not discourage saving and investment and does not inadvertently diminish the effect of the deficit reduction measures. For example, if federal expenditures are all so essential, then the obvious answer is to raise taxes by an amount sufficient to finance them. But we already have a thriving "underground" economy. Raising tax rates might not, therefore, produce the expected revenue. Similarly, tax increase measures that discouraged investment could slow the rate of growth of the economy and reduce revenues while increasing outlays, partly foiling deficit reduction efforts.

In the face of the need for deficit reduction and the possibility of a solution to this problem being effected in part through the tax structure, it becomes essential to know the policy actions that would influence personal saving favorably and adversely.

From the more narrow point of view of housing and savings institutions, it is also important to know the policy actions that would influence savings institution deposit inflows. Many of the influences on savings institution deposit inflows are competitive in nature, but many others flow through personal saving; clearly, the larger the pool of saving, the greater is the opportunity for savings institutions to compete for those funds in order to channel them into home mortgages and other earning assets.

THE DETERMINANTS OF PERSONAL SAVING:

At the most fundamental level, an individual's income provides the basis for both his consumption and his saving. Rising income generally means both more saving and more consumption, but a variety of factors then influence the relative proportions of each. For example, in the short run, "high" interest rates may influence individuals to save more and consume less; adverse economic conditions in which relatively more people expect to become unemployed may influence individuals to save more and consume less. In the long run, population demographics, marginal tax rates, the general availability of credit, the provision of retirement funds and health and life insurance all have an influence over the trends of consumption and saving.

Before attempting to quantify the extent of the influence of these factors on personal saving, it is necessary to be precise about the accounting definitions of "income" and "saving" as they are used in the discussion of saving rates.

First, the commonly-used measure of the personal saving rate is the percentage of disposable personal income not consumed. That is, one derives personal saving by subtracting personal consumption from disposable personal income. What, then, constitutes "disposable personal income" and "consumption"?

Personal income in the national income accounts consists of wages and salaries, the business income of proprietors after adjustments for the valuation of inventories and capital consumption, rental income of persons adjusted for capital consumption, dividends and interest received by persons and a host of transfer payments (Social Security, worker's compensation, Veteran's benefits, Aid to Families with Dependent Children and so forth). In addition, personal income includes employer contributions to pension funds and payments for employee life and health insurance. These payments are called "wage and salary supplements".

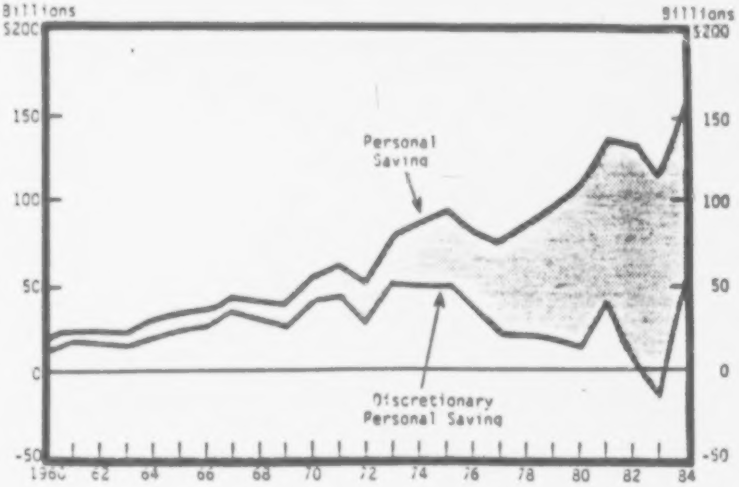
In the accounts, employer payments for employee life and health insurance are classified as consumption, while employer contributions to pension funds are considered as personal saving. In addition, the earnings on pension fund balances are treated as personal income and as personal saving. These components of personal saving do not pass through the individual's hands and should not, therefore, be considered a part of the individual's conscious and deliberate (discretionary) saving that flows into deposits, stocks, bonds and other investments.

To arrive at "disposable" personal income, taxes paid to governments and certain non-tax payments, such as license fees and fines, are subtracted from personal income.

Chart 1 illustrates the relationship between personal saving, including the increase in pension fund reserves, and discretionary personal saving. The shaded area of the chart represents the increase in pension fund reserves. It is quite clear that the growth of personal saving since about 1970 can be attributed almost exclusively to the growth of pension fund contributions and the earnings on those funds rather than to the growth of discretionary personal saving. Indeed, discretionary personal saving displayed a generally declining trend until 1984 and even became negative in 1983.

Chart 1

Personal Saving and the
Influence of Pension Funds



It is important to note that savings institutions compete at the retail level for the deposits that flow from discretionary personal saving; pension fund reserves are not accessed directly across the counter.

Basic Motives for Saving:

As a framework for the discussion of the influences on personal saving, consider that individuals have two basic motivations for not spending every dollar of income they receive.

First, the future is uncertain. Will the crops be as good next year as they are this year and will they bring as high a price? Will the company stay in business? Will the individual be able to keep his job? Will sickness strike the family? The kind of saving that flows from these concerns with the uncertainty of the future is generally known as "rainy day" saving and it has been a feature of economic behavior since the earliest days of civilization.

Second, some purchases are sufficiently large that they cannot be financed from current income. The individual has to "save up" to buy these items. Even if the purchase is partially financed with debt, a sizeable downpayment may be required. A home purchase is a prime example today.

In modern economies, a third basic motivation can be distinguished. If the society permits it, the individual can lend some of his income to another and receive payment for this service. By so doing, the lending individual has the prospect of being able to consume more in the future by postponing consumption (by saving) in the present. Alternatively, the individual may invest directly in some business or another in order to earn profit (as opposed to interest) and thereby make it possible to consume more in the future. Before the development of modern financial intermediaries, much of this kind of saving was, in fact, invested directly, either by expanding one's own business or by becoming a partner in someone else's, with the reward for saving being a share of the profit.

Finally, the individual may invest in a home which he, himself, occupies, thereby earning (imputed) rental income. This income is not recognized in the national income accounts, but it is nevertheless a form of saving for direct investment just as investing in any other business is.

In the context of these basic, structural motivations for saving, consider the forces currently influencing personal saving behavior.

Population Demographics:

Individuals pass through a "life cycle" of saving. From birth to the late teens or early twenties, the individual is dependent on his family for support--he neither earns meaningful income nor does he save. Once the individual leaves the family and strikes out on his own, he earns income, but typically not enough to provide for any significant margin of saving. Moreover, when he marries and begins to form a family of his own, the claims against his income tend to grow more rapidly than his income. Household equipment must be purchased--furniture, appliances and so forth. Children must be fed, clothed and educated. During this phase of the life cycle, the individual also typically buys a home. In our economy, many of these expenditures are debt-financed. Thus, even though the individual may be putting aside a few dollars that he considers to be saving, the debt that he is incurring probably makes him a net dis-saver; on balance, he is drawing saving from the capital pool rather than adding to it. Thus, until the children have ceased to be "dependent", the individual may be said to be in the "prime borrowing" phase of the life cycle--a period that generally spans the ages from about 25 to 45.

The individual's income may be presumed to grow through this period as his career progresses. Thus, by the time the children have left the nest, the individual's income may be approaching a career peak at the same time that the demands upon that income are declining. This is the point at which the individual enters the "prime saving" phase of the life cycle. Not only are the demands upon income declining, but the individual begins to think about retirement and about providing a pool of personal funds to supplement whatever pension income he may expect to receive. Thus, both the ability and the willingness to save grow significantly between the ages of about 45 and 65.

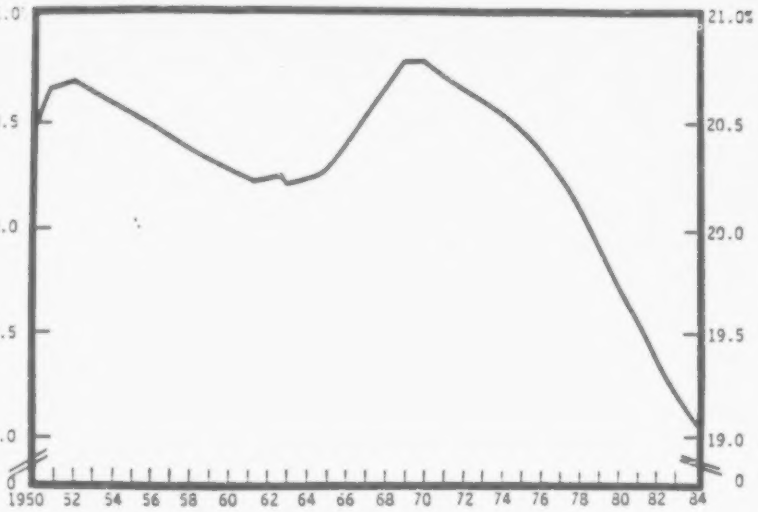
The final phase of the life cycle extends from about age 65, or the time of retirement, to death. During this phase of the life cycle, the individual may remain a prime saver if his retirement income is sufficient to support his life style and leave a margin for saving. Saving for these individuals may be motivated by the uncertainty of medical bills or home repairs or simply by a desire to leave an estate for their children or grandchildren. For others in this age group, retirement income may not be sufficient to cover more than basic needs and for still others, retirement income may not even be sufficient for basic needs, so that they are required to draw down the balances they accumulated during their prime saving years. On balance, therefore, this age group may be neutral with respect to aggregate saving.

The relative proportions of these different age groups within the population thus have a structural influence on aggregate personal saving. A relatively large number of individuals in the prime saving phase of the life cycle should produce a higher saving rate than if they constitute only a small proportion of the population.

To illustrate this point, Chart 2 shows how the proportion of the U.S. population in the prime saving phase of the life cycle has varied over time.

Chart 2

The Decline of the Prime Saver
Age Group
(Percent of Population Between Age 45 and 64)



Source: U.S. Department of Commerce

Note particularly that the prime savers have been declining sharply as a percent of the population, a factor that, for the reasons described above, can be expected to continue to depress the personal saving rate.

Income Security Programs:

Income security programs have always existed. In earlier times, the aged, the poor, the disabled and the misfortunate were cared for by the tribe, by the community or by the family. What is different today is the form, much more than the substance, of income security programs. That form nevertheless has an influence on personal saving behavior.

Beginning in the 1930s, under the inspiration of the Great Depression, governmental programs began to supplant informal private measures for maintaining income security. Social Security, unemployment insurance, worker's compensation and programs for general welfare were inaugurated during that period. It may even be said that deposit insurance and housing policy, particularly that part of housing policy directed toward homeownership, grew out of a desire to provide, through government, the kind of income security that families and communities were unable to supply during the Depression.

Later governmental programs include Medicare and Medicaid, Aid to Families with Dependent Children and Food Stamps, among others. In a very important sense, these programs have shifted responsibility from individuals and local communities to a larger community of the whole nation. As a consequence, individuals no longer feel quite as compelled to save voluntarily to insure against the calamaties of unemployment and illness or to provide for their own retirement.

Private initiatives, facilitated by law and regulation, have followed federal examples. The availability of employer-sponsored pension funds and health and life insurance has increased substantially during the post World War II period. And as a portion of the individual responsibility to save to meet economic uncertainty shifted to government, another large portion of that responsibility has been shifted to the employer. Although private pension fund contributions are included in personal income and personal saving and employer payments for health and life insurance are treated as personal income, the motivation for voluntary saving is weakened by the availability of these programs. Table 2 shows how pension fund coverage has expanded over time to cover American workers.

Table 2

Percent of Nonagricultural Wage and Salary Workers
Covered by Pension Plans

Year	Private Sector Workers Covered by Private Pension Plans	Public & Private Sector Workers Covered by Pension Plans
1950	25.0%	36.4%
1955	32.0	43.7
1960	40.8	52.1
1965	43.0	54.9
1970	44.8	56.4
1975	48.7	61.4
1980	64.7	75.2
1983	63.4	75.2

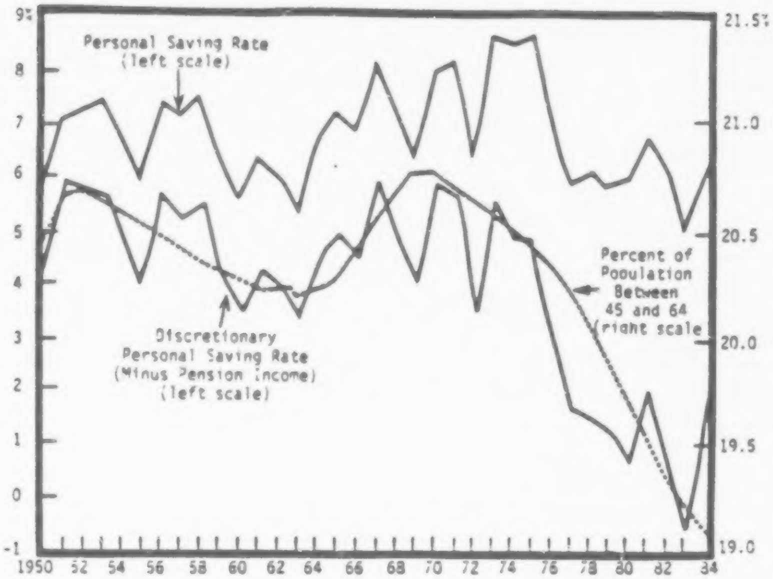
Source: Social Security Administration, Bureau of the Census and American Council of Life Insurance.

These data reveal the sharp increase in pension fund coverage since the end of World War II. Moreover, these data do not include Social Security coverage. In 1950, about 35% of the population over the age of 17 was fully covered by Social Security; in 1984, 82% of the over-17 population was fully covered.

Chart 3 shows the effect of private and state and local government pension fund contributions and earnings on total personal saving and overlays the demographics shown in Chart 2 to illustrate the close correlation between the proportion of the population in the prime saving phase of the life cycle and the discretionary personal saving rate.

Chart 3

Prime Savers, Pension Funds
and Personal Saving Rates



Source: U.S. Department of Commerce

Note in particular that the personal saving rate, excluding employer contributions to pension funds and the earnings on those funds, actually became negative in 1983.

Availability of Credit:

Although credit has long been available to American consumers through charge accounts at the local grocery store or the local department store, these credit facilities can hardly be considered in the same sentence with the prevalence of credit cards and other forms of consumer credit today. Table 3 shows the growth of per capita consumer credit, adjusted for inflation, since 1950.

Table 3

Real Consumer Credit Per Capita
(Billions of 1972 Dollars)

Year	Total	Non-Installment Credit	Installment Credit				
			Automobile	Revolving	Mobile Homes	Other	Total
1950	$444.9	$175.2	$107.3			$162.4	$ 269.7
1955	664.1	217.4	202.1			244.6	311.8
1960	793.7	243.2	224.8			325.6	550.4
1965	1,081.3	307.3	312.3			461.7	774.0
1968	1,146.3	319.4	315.2	18.6		493.1	826.9
1969	1,161.4	309.2	316.8	30.6		504.9	852.3
1970	1,124.8	296.0	289.9	39.1	19.4	480.4	828.8
1971	1,155.4	290.5	301.0	61.3	53.3	449.3	864.9
1972	1,216.2	305.5	331.9	65.2	65.7	448.0	910.7
1973	1,284.4	306.8	343.6	72.4	86.3	475.3	977.6
1974	1,219.2	280.3	314.0	76.6	84.4	463.9	938.9
1975	1,140.8	261.5	297.3	75.1	74.7	432.2	879.2
1976	1,185.3	262.3	328.1	79.9	70.3	444.7	922.9
1977	1,277.8	260.2	372.2	163.6	66.9	415.0	1,107.6
1978	1,366.7	260.6	418.3	184.8	62.4	440.7	1,106.1
1979	1,401.1	261.1	432.5	197.4	57.8	447.5	1,139.9
1980	1,280.5	245.8	390.3	183.4	57.8	403.2	1,034.8
1981	1,230.9	238.5	376.6	181.2	53.7	380.8	992.3
1982	1,213.4	236.6	363.3	183.2	61.9	368.3	976.7
1983	1,290.8	254.7	378.2	201.4	62.5	394.0	1,036.2
1984	1,457.0	285.1	425.0	236.2	65.2	445.6	1,171.9

Source: Federal Reserve Board.

Notes: (Changes in classifications in 1977.)

Credit availability clearly reduces the need to "save up" to finance consumer expenditures and thus weakens the motivation for saving. Add to this federal programs, only recently scaled back, to provide loans to finance college educations and the availability of low- and no-downpayment home mortgages and one must conclude that, while the availability of credit has contributed substantially to the material standard of living of Americans, it has also contributed to "low" personal saving rates.

Inflation:

Although individuals have a tendency to ignore the rate of inflation in their short-term saving decisions, the real, or inflation-adjusted, rate of return is a powerful factor in the long run. To illustrate, a 10% nominal return may be quite appealing when the inflation rate is zero and quite unappealing when inflation is running at 10%. In developing countries, where inflation tends to be endemic, individuals save either in hard currency or in tangibles, which may be classified as consumption expenditures. The same proved true in the United States during the late 1970s, when individuals began to realize that their "real" rates of return were, in many cases, negative. They began shifting their portfolios to such tangibles as real estate and to so-called "collectibles"--tangible goods whose value could be expected to increase with a continuation of inflation--and to gold and silver.

Inflation also has the effect of reducing the personal income available for saving. Under all but very moderate rates of inflation, the prices of goods and services purchased by consumers tend to rise faster than wages and salaries.

If inflation persists over any extended period of time, saving behavior can be altered permanently. Individuals become ingrained with the belief that financial assets cannot be relied upon to yield a positive real rate of return. Tangible assets, debt-financed if possible, then become the preferred medium for individual saving.

Table 4 shows how inflation in the late 1970s and, to a lesser degree in the late 1950s, reduced real rates of interest on short-term and long-term U.S. government securities. Indeed, the real rate of interest on three-month Treasury bills was negative from 1974 through 1980; even the real rates of return on 10-year Treasury bonds were negative in 1974-75 and 1979-80.

All of these yields are, of course, pre-tax yields. When one considers the taxability of the interest earnings on these securities, real after-tax yields were much smaller than those indicated in the table.

Table 4

Real Rates of Return on U.S. Treasury Securities (Percent)

Year	Three-month Treasury Bill	10-Year Treasury Bond
1955	2.126%	3.193%
1956	1.162	1.684
1957	-0.296	0.087
1958	-0.861	0.620
1959	2.605	3.530
1960	1.328	2.520
1961	1.378	2.880
1962	1.678	2.850
1963	1.957	2.800
1964	2.249	2.890
1965	2.254	2.580
1966	1.981	2.020
1967	1.421	2.170
1968	1.139	1.450
1969	1.277	1.270
1970	0.558	1.450
1971	0.048	1.860
1972	0.771	2.910
1973	0.841	0.640
1974	- 3.114	- 3.440
1975	- 3.262	- 1.110
1976	- 0.811	1.810
1977	- 1.235	0.920
1978	- 0.479	0.710
1979	- 1.259	- 1.860
1980	- 1.994	- 2.040
1981	3.629	3.510
1982	4.586	6.900
1983	5.430	7.900
1984	5.280	8.140

Source: Federal Reserve Board.

Tax Treatment:

The U.S. tax system has, for many years, been biased in favor of consumption and against saving. The current tax code permits the deduction of interest paid on loans of all types, but taxes most interest and dividend income at ordinary income tax rates. In effect, this tax treatment reduces the cost of borrowing while it also reduces the return to saving. The Economic Recovery Tax Act of 1981, by reducing marginal tax rates, contributed slightly to redressing this imbalance, but signifcant restructuring of the net tax incentives to save must await the enactment of major tax reform measures of the sort now being considered in the Congress. The general thrust of the current tax reform proposals is to eliminate or substantially reduce the deductibility of consumer interest and to lower marginal tax rates still further, thereby raising the after-tax cost of consumer borrowing and increasing the after-tax return to saving.

These structural factors influence the general trend of personal saving in the long run. Over the business cycle, several additional factors operate.

Perhaps the most visible of the remaining basic influences on personal saving is that of the return to saving, as reflected in interest and dividend returns and in the cost of borrowing not incurred. But this is not the only factor that influences personal saving in the short run or over the cycle.

Uncertainty:

Although workers who lose their jobs receive unemployment benefits, the payment amounts and the time for which benefits can be received are distinctly limited. Consequently, workers who anticipate the possibility of being laid off are quite likely to begin to reduce their indebtedness and build up their savings balances. This effect becomes generalized when the economy moves into recession.

Interest Rate Movements and Wealth Effects:

Generally speaking, an increase in interest rates available on financial assets should encourage individuals to postpone current consumption and to save more, simply because the reward for saving has increased. Furthermore, that same rise in interest rates serves to discourage borrowing, so that individuals may be forced to postpone their debt-financed consumption and to save more by default.

An additional effect of rising interest rates is to reduce the value of fixed rate assets (i.e., bonds) already held in portfolio and therefore to reduce wealth. At the same time, if stock prices move in the same direction as bond prices, the value of stocks held in portfolio will also decline.

These wealth effects influence saving behavior to the extent that individuals have certain "target" levels of savings that they seek to achieve and maintain. For example, an increase in interest rates that serves to reduce existing wealth will be unambigously favorable to increased saving; individuals will not only respond to the incentive to save out of current income because of the greater reward and will respond to the disincentive to consume because of the higher cost of borrowing, they will also respond to a felt need to restore their wealth to its target level by adding to their balances.

Conversely, falling interest rates tend to increase the value of existing portfolios, perhaps to levels exceeding the "target" levels, reducing the incentive to save from current income and the disincentive to debt-finance current consumption. Falling interest rates should therefore produce lower levels of personal saving.

These short-run influences on saving behavior can be combined with the longer-term influences discussed above to provide a quantitative perspective on personal saving behavior. Using econometric techniques, we can determine the relative importance of most (not all) of these influences on personal saving.

THE PERSONAL SAVING EQUATION:

In this section of the paper, we present the results of fitting an econometric equation to personal saving. The process by which this is accomplished is technical and need not detain us. It is sufficient to say that the process relates variables representing the influences on personal saving behavior discussed above in such a way that we are able to determine the relative importance of each of these "explanatory" variables.

Because we are ultimately interested in linking personal saving to deposit growth at savings institutions, we define personal saving here as "discretionary" saving. That is, we subtract from personal saving and from after-tax personal income the pension fund contributions of employers and the earnings on pension fund reserves. This adjustment yields a measure of the personal saving from which retail deposits must be drawn. Savings institutions do obtain some deposits from pension funds, but primarily in the form of large denomination certificates of deposit. This element of total savings institution deposits is accounted for in the equation that relates discretionary personal saving to savings institution deposits.

Table 5 presents the coefficients of each of the "explanatory" variables and their relative importance in accounting for variations in discretionary personal saving. Each of these coefficients has been determined to be statistically significant at the 99% confidence level, which simply means that there is only one chance in a hundred that the coefficient is, in fact, zero and that the explanatory variable in question is unrelated to discretionary personal saving. Several other properties of the equation will be explained below.

A visual impression of how well the equation "explains" discretionary personal saving can be obtained from Chart 4, which plots the actual levels of discretionary personal saving against those derived from the equation.

Table 5

Parameters of the Discretionary
Personal Saving Equation
(1960-1984)

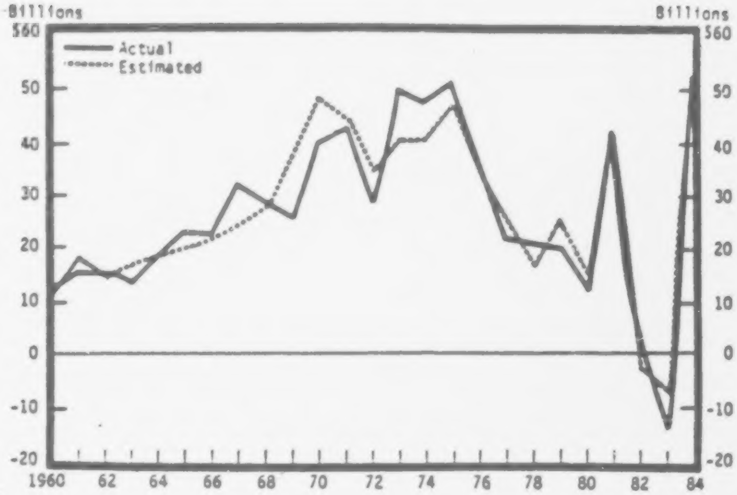
Explanatory Variable	Coefficient	Standard Error of the Coefficient	Mean Elasticity
Discretionary Personal Income ($ Billions)	0.0884	0.0095	3.05
Change in Pension Fund Reserves ($ Billions)	- 1.5547	0.1592	-2.29
After-tax Yield on One-Year Treasury Bills (Percent)	6.8345	1.4428	1.19
Population Aged 45 to 64 (Prime Savers) (Millions of People)	0.0018	0.0006	2.48
Population Aged 25 to 44 (Prime Borrowers) (Millions of People)	- 0.0027	0.0006	-4.83
Unemployment Rate (Percent)	6.3842	1.4129	1.28

Goodness of Fit Statistics:

$\overline{R}^2$ = .8698
SEE = $5.767 billion
DW = 1.782

Chart 4

Actual and Estimated -
Discretionary Personal Saving



The coefficients of the equation shown in Table 5 are to be interpreted as follows: For every one billion dollar increase in discretionary personal income--with all other variables remaining constant--discretionary personal saving can be expected to increase by $88.4 million. For every one billion dollar increase in pension fund reserves--with all other variables remaining constant--discretionary personal saving can be expected to decrease by $1.555 billion. For every one percentage point increase in the after-tax rate of return on one-year T-bills--with all other variables remaining constant--discretionary personal saving can be expected to increase by $6.834 billion. (Here it must be recalled that this one interest rate is representing the combined influence of the after-tax rate of return, the after-tax cost of borrowing and the several wealth effects associated with changes in interest rates; we are unable to isolate the separate effects of these closely-linked influences.)

To continue, for every increase of one million persons in the prime saving age group (age 45 to 64)--with all other variables remaining constant--discretionary personal saving can be expected to increase by $1.8 million. Similarly, for every increase of one million persons in the prime borrowing age group (age 25-44)--again assuming that all other variables remain constant--discretionary personal saving can be expected to decline by $2.7 million. And finally, for every one percentage point increase in the unemployment rate--still with all other variables assumed to remain constant--discretionary personal saving can be expected to rise by $6.384 billion.

From these statistics alone, one would reach the conclusion that the after-tax rate of return and the unemployment rate have the greatest effects on discretionary personal saving. The mean elasticities, which adjust the coefficients for the differences in the form in which they are expressed (billions, millions, percent), tell a somewhat different story.

The mean elasticities, which can be interpreted as measures of relative importance, indicate the degree of sensitivity of discretionary personal saving to each variable. To illustrate, a one percent increase in discretionary personal income can be expected, on average, to increase discretionary personal saving by 3.05%, still assuming that all other variables remain unchanged; a one percent increase in the number of people in the prime borrowing phase of the life cycle can be expected, on average, to reduce discretionary personal saving by 4.83% and so on.

On this basis, it can be determined that discretionary personal saving is most sensitive to the demographics of the life cycle and to personal income and that it is more sensitive to pension fund contributions and even to the economic uncertainty represented by the unemployment rate than it is to the after-tax rate of return.

These findings strongly suggest that policy initiatives directed toward increasing the after-tax rate of return must, in practice, overcome other, much more powerful influences on discretionary personal saving before they can be expected to have a positive effect on saving.

Even though the measure of relative importance of the after-tax rate of return indicates that a one percent increase in the rate of return would increase discretionary personal saving by 1.19% if all other variables were held constant, the other variables cannot, in fact, be held constant. The demographics, for example, are not only the most powerful influence on discretionary personal saving, they are also the most inexorable and the the most unfavorable to discretionary personal saving. According to Census Bureau projections, the current demographic trends will not begin to be reversed until 1987 and demographics as favorable to discretionary personal saving as those that existed in the early 1970s will not return until after the turn of the century.

These findings may explain, to a significant extent, why efforts in the late 1970s and early 1980s to provide tax incentives for saving (the $200/$400 exclusion and the All Savers Certificate, for example) were judged to be unsuccessful and why the Individual Retirement Account provisions appear to cost the savings pool much more in foregone tax revenue than they yield in additional personal saving.

These findings also suggest that policy initiatives, such as marginal tax rate reductions, that increase discretionary disposable personal income have a better chance of overcoming the adverse influence of the demographics and producing an increase in discretionary personal saving.

What can one say about the negative influence of the growth of pension funds on discretionary personal saving? The size of the coefficient of the pension fund variable in the discretionary personal saving equation indicates that for every dollar that pension fund reserves grow, discretionary personal saving _falls_ by a dollar and a half. Notwithstanding that the pension fund variable may also serve as a proxy for a variety of other income security programs provided by government and private employers, so disproportionate a reduction in discretionary saving as a result of an increase in pension fund reserves suggests that individuals may not be well informed about the implications of their actions.

Consider the possibility that, in the absence of complete information about their pension plans (and their benefits under other programs), individuals simply _assume_ that their retirement benefits will be adequate to support them at an acceptable standard of living. Going on that assumption or on the assumption that by the time _they_ reach retirement, whatever programs are then in existence _will_ be adequate, they neglect to save from discretionary income. Indeed, feeling that their current contingencies are convered by employer-provided group health and life insurance and that their retirement needs are convered by employer-funded pension plans, by Social Security and Medicare, individuals are left with very little need to save from discretionary income.

Whether or not current programs are, in fact, adequate is a matter for each individual to determine. It is likely, however, that individuals do not receive sufficient information or information in an appropriate form to make that determination. Reporting requirements under the Employee Retirement Income Security Act are extensive and thought to be quite burdonsome for employers, yet many pension plan recipients do not receive the status reports required by ERISA or do not receive such information in a form that lends itself to retirement planning by the individual. With such information in hand, in an appropriate form, individuals would be much better able to assess the adequacy of their saving balances and to determine whether or not they needed to save more.

CONCLUSIONS:

From the national economic policy perspective, several conclusions seem warranted. First, given the population demographics, there are no realistic policy actions that can be imagined that could be expected to increase personal saving sufficiently to accommodate the enormous federal budget deficits that we currently face. The analysis presented here does not directly indicate how the problem of the federal deficits must be dealt with, but previous staff papers make out a case in terms of spending reduction rather than tax increase. Indirectly, our analysis of personal saving behavior supports this case.

Second, after-tax discretionary income emerges as the most important influence on discretionary personal saving behavior when the demographic effects are netted out. Policies that serve to increase after-tax income can therefore be expected to have the most powerful positive effects on personal saving. By contrast, policies directed explicitly toward increasing the after-tax rate of return are unlikely to be successful in significantly raising discretionary personal saving.

This conclusion is warranted even though we are unable to disentangle the separate effects on overt saving, borrowing and wealth. Happily (perhaps) the tax reform proposals currently being discussed move in the "right" direction on all counts. Lowering marginal tax rates should have the effect of increasing after-tax discretionary income, as well as raising the after-tax rate of return on saving. And abolishing the consumer interest deduction would have the effect of increasing the after-tax cost of borrowing. All of these effects move in the direction of encouraging personal saving.

Third, pension funds swirl in the vortex of the issues linking the national interest in reducing the federal deficits and increasing personal saving and the more narrow interests of savings institutions in maintaining the growth of their deposit inflows.

The evidence rather convincingly indicates that the income security measures that both the public sector and the private sector have adopted weaken the impulse to save. But it is difficult in the extreme to argue that these are inappropriate policies for that reason. Even within the context of the issue of personal saving, the growing dominance of pension fund contributions in personal saving provides the largest tax incentive of all. Private pension fund contributions and the earnings on those contributions are tax-deferred and they do flow directly into the capital pool.

Pension reform, or more broadly a reform of income security programs, may be an avenue down which reasonable men could go, but an advocacy of reducing the income security of Americans is not a position with which many could be comfortable on either moral or economic grounds.

It remains to be seen, however, whether individuals are adequately informed about the benefits from private and public programs that they might reasonably expect to receive in retirement. If Americans are operating today on false assumptions about the adequacy of these benefits and failing to save sufficient amounts from their discretionary income to make up the difference, they will surely seek redress from government programs when the realization finally dawns on them.

Public policy measures should therefore be taken today, not only to remove the tax penalities associated with saving and investing and the tax incentives associated with consuming and borrowing, but also to shift the burden of responsibility back to individuals by informing and educating Americans about their current private and public benefits.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman.

Mr. Caspersen, as you indicate in your testimony you speak on behalf of a host of middle-income Americans, who use the services of your company. And so, you speak about the two specific deductions you feel are important: the home mortgage interest and the deductibility of consumer interest. What is your view on the deductibility of State and local taxes? I am not sure whether you touched on that with Senator Bradley, but I would like to ask you, anyway.

Mr. CASPERSEN. In the current bill, that of course, as we all know, provides the revenue to provide revenue neutrality or neutrality here. We have no particular stance on it. We recognize there are some very serious problems with it as drafted, and particularly in some certain States.

Our viewpoint on that would be that the important thing is to have a revenue-neutral bill to provide a level playing field, and if that current stance of nondeductibility is not appropriate or just can't be done, then let us tinker with it and come up with a revenue-neutral compromise.

Senator CHAFEE. You say on page 5 that the present code is riddled with provisions for special interest groups. Could you name a couple?

Mr. CASPERSEN. Well, that is a little evocative statement.

Senator CHAFEE. Well, it is your statement, not mine.

Mr. CASPERSEN. I know.

The code was drafted over an ongoing period, as we all know. During that period, at some times capital formation in terms of ITC, in terms of accelerated depreciation, in terms of the oil areas, even in terms, apparently, of motion picture areas, certain areas were found to be important and were shaped so that you could have favorable tax subsidies or tax deductions. Those are the areas which have become strongly protected. As soon as one allows usage of the Tax Code to favor a specific industry, you begin to have vested interests, and that is what we are seeing right now. And I think you see it far better than I.

Senator CHAFEE. Mr. Perkowski, why should a credit union be treated differently than a mutual savings bank?

Mr. PERKOWSKI. Senator, the credit unions are cooperative. It is a member-owned cooperative, and I believe that is the basic difference. We are nonprofit, and we are owned by our members.

Senator CHAFEE. Well, so is a mutual savings bank.

Mr. PERKOWSKI. I don't know what happened in 1951, Senator, when the exemption was taken away. I wasn't here. But it seems obvious that one of a couple of things must have happened. Either the direction changed of the organization and somebody felt they weren't doing what they were originally chartered to do, or maybe they wanted to pay taxes to give them opportunities to do other things—for example, commercial loans.

Senator CHAFEE. Well, we never have anyone come in here who wants to pay taxes.

Mr. PERKOWSKI. Well, you wouldn't argue against it as much, possibly.

Senator **Chafee**. Well, I read your statement here, and I have had the opportunity to meet with the representatives from the credit unions. Of course, they are very strong in my State, and I am sympathetic toward them; but it does seem to me that here is a case in which there does appear to be some unfairness.

Now, this has come up with us many times, regardless of whether we are dealing with tax reform. It has come up when we are just looking for more revenue.

One of your points that I find of interest is, first, "Credit unions shouldn't be taxed because they make decisions purely on meeting the needs of their members; they are free from the artificial influence of the Tax Code." I think everybody would like to be in that situation, free from the artificial influence of the Code. But when you get some of these tremendous credit unions—and as you mentioned the Navy one, truly does serve its members as you point out by carrying very small accounts—we are taxing everybody else and I am not quite sure why credit unions should escape taxation—modest, perhaps, but tax, nonetheless.

Mr. **Perkowski**. Well, our contention is that we are different than everybody else, Senator. We contend that we do provide a social service to our members, by not paying fees, by getting lesser loan rates, and we feel that we do our things voluntarily. We have not cost the Government any money to maintain our organizations. And we would see that changing dramatically if we had to pay taxes, and if we had to send money to Washington. I think if we had some difficulties, it would be natural to look to Washington.

In addition, I would like to point out that last year we funded our NCUA insurance fund.

Senator **Chafee**. I remember that, yes.

Mr. **Perkowski**. And just to maintain that 1-percent level this year, it is estimated that we would put in another $180 million. And the numbers from Treasury-II suggest that the total tax bill would be $200 million. In other words, voluntarily we are nearly matching it on our own.

Senator **Chafee**. Well, I think you folks do provide a wonderful service. I am not gainsaying that one bit. I think certainly you do provide service as you point out in your testimony in describing what the Navy Federal Credit Union does.

Fine. Thank you.

The **Chairman**. Senator Symms.

Senator **Symms**. Thank you, Mr. Chairman.

Just to pursue Senator Chafee's questions, in my State most of the credit unions are very small savers, and in most cases are wage earners that are members of credit unions. And I am told by the credit union association in Idaho that if this tax were to pass that it would severely crimp their ability to take care of these very small savers. Is that true?

Mr. **Perkowski**. That is correct, Senator. Something would have to give. Either it would be at the expense of safety and soundness, and that is we would put less money in our reserves and our equity accounts, and today I think we are the safest of all; or, we would have to pass on the tax burden to our members. And I think we would have to look at virtually all of those services. If it was a $5 account, could we afford to keep a $5 account? Would that cost too much, et cetera, et cetera. And I think it would be part of the management process to review the entire operation. And some of those services that we provide free of charge today possibly would have to have fees attached to them.

Senator SYMMS. Do any of the others of you want to comment on that? Do you think the other banking services that are available would fill that gap? Or, even, do you want the business of the person that has an account that is less than $100 in many cases and maybe would borrow $200 or $300 or $400 as a maximum type of a loan?

[Pause.]

Senator SYMMS. Any of you? [Laughter.]

Mr. PERKOWSKI. We would be delighted to keep the business . [Laughter.]

Senator SYMMS. Thank you, Mr. Chairman.

The CHAIRMAN. Any other questions? Max.

Senator BAUCUS. This may be a little too far reaching, but it has struck me, with deregulation in the financial services area, the degree to which other countries' financial institutions are coming to this country for business.

In my home State of Montana, I am struck by the number of businessmen who come up to me and tell me they have been approached by foreign banks for business in Montana, and I think that is a trend that is probably going to continue.

In the same vein, it is clear that the world is changing dramatically; our competitive position is under a terrific strain. Many companies are either moving offshore or thinking about moving offshore; foreign companies and countries are increasing dramatically their productivity and their competitive position.

I guess my concern is, that the United States might not always be the financial center. It may be in Tokyo or in Europe somewhere. As other countries begin to compete in more products, financial institutions may be closer to those companies.

My real question is the degree to which the Tax Code should address the U.S. competitive position, and in the context of today's hearing, particularly as it affects U.S. financial institutions.

Mr. OLSON. Senator, you correlated deregulation and the fact that some of your constituents were being approached by foreign banks.

Senator SYMMS. Correct.

Mr. OLSON. In the banking industry, basically what has happened in deregulation so far is that we have deregulated interest rates. To the extent that banking has been deregulated with respect to offering the products, it hasn't happened yet. There has been a lot of discussion, but it hasn't happened. So I don't know to what extent there is a correlation.

Senator SYMMS. Let's assume it is only interest rates. Go ahead; I am just curious about the degree to which we should in the Tax Code try to protect or enhance U.S. financial institutions' competitive positions vis-a-vis other countries' financial institutions, and, second, U.S. business generally. Or should we just open it wide up and forget about it?

Mr. Olson. Again, our foreign businesses in Fergus Falls is limited principally to exchanging Canadian currency. I would like to defer that question to Gordon Martin.

Mr. Martin. Well, Senator, there is one aspect of the Tax Code that I think deserves some attention. It is one that we would like you to focus on, and that is the foreign tax credit area.

The present system is an overall type of credit. The system that is proposed is one that would limit it to a per-country type calculation. That new methodology is one that would put us somewhat out on a particular leg that would be completely different from most of the other countries of the world. That certainly would be a competitive disadvantage for U.S. financial institutions. That, in addition to its complexity, is something that would warrant our serious concern as to whether or not that new system is one that we should adopt.

Senator Symms. Anyone else?

Mr. Morris. One comment in relation to our business. First, in the broad context we are pretty much localized home-owned lenders.

In terms of getting capital from overseas, one problem we have at the present time is the sale of mortgage-backed securities to a foreign investor. Mortgage-backed securities are not exempt from the 30-percent withholding. So that would be a help from the mortgage standpoint to pull additional capital in if that were changed.

Mr. Caspersen. One further comment on the premise of your question. The U.S. financial system, despite the regulations, remains, and as was correctly described is still the freest in the world for outsiders to enter. That is not so for the rest of the world. And part of the current trade negotiations are aiming at freeing up the rest of that.

Senator Symms. I understand.

Mr. Caspersen. That is an incredibly important point. They can enter us; we can't enter them.

Senator Symms. Thank you.

Thank you, Mr. Chairman.

The Chairman. Senator Long.

Senator Long. I want to ask Mr. Perkowski a question. Do the credit unions benefit from a substantial amount of free services from their members? In other words, are the people who serve on the boards of the credit unions paid a salary, or do you have just one or two people in the credit unions who are paid a salary?

Mr. Perkowski. The people serving on the board, Senator, are volunteers, and in most States and in all Federal credit unions they are not paid a salary, are prohibited from getting a salary for that service.

Senator Long. So, it would be fair to say that in the overwhelming majority of cases the people who serve on the boards are not paid anything?

Mr. Perkowski. That is correct.

Senator Long. So, they do it because they are interested in their fellow employees?

Mr. Perkowski. Absolutely.

Senator Long. If I understand correctly, this is a situation where employees, whether it be the Navy or whatever, work together.

Some of them loan some money to their credit union, and the credit union makes available, loans to the employees. Many times those are loans that would not be available elsewhere. Is that correct?

Mr. PERKOWSKI. That is correct, sir.

Senator LONG. I understand that the loans are all on reasonable terms. I mean, there is no high interest rate such as 3 percent a month. Is that right?

My recollection is that if a fellow would go to a small loan operation in Louisiana, he would pay something like 3.5 percent a month to borrow money. You do not pay anything like that if you are borrowing from a credit union. Is that correct?

Mr. PERKOWSKI. Our current rates at our credit union in Minneapolis are 10.5 percent—that is an annual rate—for new car loans, and in addition we provide a credit life. Or just your signature loan line of credit is 13.5 percent.

Senator LONG. Suppose one of your fellow employees has fallen on bad times and needs to borrow some money because things are tight. He discusses his problem with the person who runs the credit union—you usually have one salaried employee or one person who is paid to keep the books and that type thing, don't you?

Mr. PERKOWSKI. Yes, sir.

Senator LONG. So, he discusses it with that person. Then the credit union board discusses it, and they agree to make him the loan. So, he gets a loan for maybe 10.5 percent. If he had to go to a small loan company, he might be paying over 40 percent on an annual basis. That is the kind of thing we are talking about—where employees help one another by lending their money to the credit union, and getting whatever they think the credit union can afford to pay.

What are those who loan their money to their credit union getting right now?

Mr. PERKOWSKI. It depends on how you save the money with the credit union. In our particular case, we have a regular savings account. We provide 5.5 percent on a daily basis, but we provide $2,000 worth of life insurance with that. We have a deposit account that pays 6.5 percent—those are the so-called passbook savings. The rest of our rates, our certificates, et cetera, are pretty much market influenced, and it is based on what the particular market is.

Senator LONG. Right. But basically, the employees are putting their money with their credit union, and what they are getting as a return is maybe a little less but certainly not much more than they would get if they were investing in the commercial market. Is that correct?

Mr. PERKOWSKI. Yes. Yes, across the board the rates are about 7.5 percent or 7.8 percent.

Senator LONG. It seems to me that it would almost compare to a situation where one employee falls on bad times and his fellow employee and friend makes him a loan to tide him over a tight spot.

What is the philosophy of the Government proposal to tax the credit unions?

Mr. PERKOWSKI. Well, I guess that is our question. By putting the $5 million threshhold, you know, it suggests to us that all of a sudden, because you have achieved a size, you are no longer a credit union and you lose your philosophy. And I guess, Senator, that is why we try to make the point about Navy Federal and many of the larger credit unions. They are large only because they have that many more members to serve, and they don't change any more than the little credit union that you were talking about.

Senator LONG. In other words, it is one thing to tax a credit union, if by growth it has become a bad guy. But it is another thing if it is growing because it is doing a good job, and that is how most businesses grow. I take it that credit unions grew because they were doing a good job. Is that fair?

Mr. PERKOWSKI. That's fair.

The CHAIRMAN. You're sure it's fair?

Mr. PERKOWSKI. Yes, sir.

Senator LONG. That being the case, it doesn't make much sense to tax it; at least in your judgment it doesn't. I don't think it does either.

Mr. PERKOWSKI. No.

Senator LONG. Thank you.

The CHAIRMAN. Gentlemen, thank you very much; we appreciate it.

Next, if we might, we have a minerals panel consisting of of Mr. E.B. Leisenring, Mr. John Kelly, Mr. Dennis Bedell, and Mr. Kurt Swenson.

I also see joining us today is our old friend Bob McClory, who served for years in the House and with whom this committee has had many happy dealings, and I have had many personal happy dealings with him.

Mr. MCCLORY. I am accompany them.

The CHAIRMAN. That is what I understand, but we are glad to have you with us. They picked somebody good to accompany them.

Mr. Leisenring, why don't you go ahead and start.

STATEMENT BY E.B. LEISENRING, JR., CHAIRMAN AND CHIEF EXECUTIVE OFFICER, WESTMORELAND COAL CO., PHILADELPHIA, PA; ON BEHALF OF THE NATIONAL COAL ASSOCIATION

Mr. LEISENRING. Thank you, Mr. Chairman.

Members of the committee, thank you for affording me the opportunity to comment on the President's tax proposals. My name is Ted Leisenring. I am chairman and chief executive officer of Westmoreland Coal Co. of Philadelphia. I am also a member of the board of directors of the National Coal Association and past chairman of its Tax Committee. I will assure you that I will take less than 5 minutes to summarize the effect of the tax proposals on the American coal industry.

The National Coal Association commissioned the firm of Price Waterhouse to study the impact of the President's tax proposals on the coal industry. An executive summary of that study is appended to my statement. The survey represents companies producing over 47 percent of the Nation's coal, equally divided between East and West, deep and surface mining, large and small companies.

The study has determined that the projected impact of the President's proposal on the industry will prove an extreme financial hardship. Based on this survey, to begin with, the net federal income tax generated by coal operations amounts to approximately $320 million per year in recent years. The tax reform proposals would increase the tax on the industry by an average of $200 million per year in each of the first 5 years, an average tax increase of 62 percent as compared to the present law. The 1-year tax increase is $170 million in 1986 and rises to $260 million by 1990.

The phaseout of percentage depletion alone would add $904 million to the taxes to be paid by the coal companies during the first 5 years of the proposed change.

Proposals of the Administration would adversely impact most capital-intensive industries, but it would hit coal mining, one of the most capital-intensive, especially hard because of the loss of percentage depletion. Specifically, it would hit the coal producer hardest of all by the added loss of capital gains treatment for coal royalties, and tax loss accrual of reclamation reserves.

Finally, the proposed higher taxation for black lung benefits and workmen's compensation would result in higher coal costs and therefore added costs to the consumer.

I would like especially, Mr. Chairman, to give highest commendation to you and the members of this committee for recently rejecting a proposal to increase taxes on black lung funding by a proposed disastrous 50 percent.

Major tax reform must not be accomplished if it contains such a serious disruption to the coal industry. Every provision in the Tax Code was enacted to achieve certain desirable objectives in our complex economy. Coal is essential to our national security program. Imported oil has proven to be an unreliable and disruptive source. Oil and natural gas are limited. Coal represents over 80 percent of our country's fuel reserves, and it is vital to the Nation.

In the last 10 years, coal consumption has increased by 41 percent, while our total energy demand has grown very little. As a result, coal's share of national energy consumption has grown from 18 percent to 23 percent. Here is a very key figure, gentlemen: Coal's share of electricity generation, where imported oil has been displaced, has grown from 44 percent to 56 percent of the electricity in this country generated by coal. The primary reason for this has been coal's ability to compete with other forms of energy, both domestic and imported.

While intangible drilling costs for oil and gas have been appropriately retained in the administration's proposal, that ingredient of the Tax Code which contributes most to coal's future, percentage depletion, is slated for elimination.

The problem with oil and gas is to find it. Once found, there is a finite expense of producing and marketing oil and gas. Accordingly, maintaining favorable tax treatment for intangible drilling costs is a necessary incentive for the oil and gas industry. With coal, the problem is producing it at a competitive cost. Despite high rail rates and the cost of expensive government regulations, no single change in the Tax Code would more damage the supply of American coal than the elimination of percentage depletion. In addition to contributing to America's drive to energy independence, coal contributes positively to our ever-worsening balance of payments problem. We exported 81 million tons in 1984 and contributed $4 billion to the positive side of the balance.

We are hindered by competing effectively in the steam coal market by the strong dollar overseas, high inland rail rates, and high regulatory costs. In fact, we have difficulty competing with foreign coal in some regions of our own country. Now, foreign coal is being imported into the Gulf Coast States at $5 to $7 cheaper than our coal can be produced in Appalachia, coming from the Republic of Colombia.

Richard Trumka, president of the United Mind Workers of America, declared in a recent interview, and I quote, 'If the depletion allowance is removed, the price of domestic coal will go up and more and more imports will be sought by our domestic customers, thus resulting in greater unemployment here at home. The depletion issue, you see, affects each of us directly.'

Frankly, we cannot accept the theory that the President's proposal will result in an overall benefit by assuming that capital and labor will be directed into more productive channels. You cannot burn computers in a utility boiler, and few coal miners can be trained to become electronics specialists. It is entirely wrong to cripple those capital-intensive industries led by mining which are the backbone of our economy.

Gentlemen, thank you for the opportunity to place these facts on the record.

The CHAIRMAN. Thank you, sir.

Mr. Kelley.

[Mr. Leisenring's written testimony follows:]

STATEMENT OF THE NATIONAL COAL ASSOCIATION

by

E.B. LEISENRING, JR.

CHAIRMAN AND CHIEF EXECUTIVE OFFICER
of
WESTMORELAND COAL COMPANY

MR. CHAIRMAN, MEMBERS OF THE COMMITTEE:

THANK YOU FOR AFFORDING US THE OPPORTUNITY TO COMMENT ON THE PRESIDENT'S TAX PROPOSALS.

I AM E.B. LEISENRING, JR., CHAIRMAN AND CHIEF EXECUTIVE OFFICER OF WESTMORELAND COAL COMPANY OF PHILADELPHIA, PENNSYLVANIA. I AM ALSO A MEMBER OF THE BOARD OF DIRECTORS OF THE NATIONAL COAL ASSOCIATION AND PAST CHAIRMAN ~~OF ITS TAX~~ COMMITTEE.

I WOULD LIKE TO OPEN MY REMARKS BY NOTING THAT THE NATIONAL COAL ASSOCIATION COMMISSIONED THE CPA FIRM OF PRICE WATERHOUSE TO STUDY THE IMPACT OF THE PRESIDENT'S TAX PROPOSALS ON THE COAL INDUSTRY. AN EXECUTIVE SUMMARY OF THAT STUDY IS APPENDED TO MY STATEMENT. THE MEMBERS OF THIS COMMITTEE HAVE BEEN PROVIDED COPIES OF THE FULL STUDY. THE SURVEY UPON WHICH THE STUDY IS BASED REPRESENTS COMPANIES PRODUCING OVER 47 PERCENT OF THE NATION'S COAL, VERY EQUALLY DIVIDED BETWEEN EAST AND WEST, DEEP AND STRIP, LARGE AND SMALL.

THE STUDY HAS DETERMINED THAT THE PROJECTED IMPACT OF THE PRESIDENT'S PROPOSAL ON THE COAL INDUSTRY WILL PROVE AN EXTREME FINANCIAL HARDSHIP.

- BASED ON THIS SURVEY, THE NET FEDERAL INCOME TAX ATTRIBUTABLE TO COAL OPERATIONS IS APPROXIMATELY $320 MILLION PER YEAR IN RECENT YEARS.

- THE PRESIDENT'S TAX REFORM PROPOSALS WOULD INCREASE THE TAX ON THE INDUSTRY BY AN AVERAGE OF $200 MILLION PER YEAR IN EACH OF THE FIRST FIVE YEARS, AN AVERAGE TAX INCREASE OF 62% AS COMPARED TO THE PRESENT LAW. THE ONE-YEAR TAX INCREASE IS $170 MILLION IN 1986, AND RISES TO $260 MILLION BY 1990. THIS ESTIMATE TAKES FULL ACCOUNT OF MINIMUM TAXES, LOSS CARRYOVERS, AND TRANSITION RULES, AS WELL AS PROPOSED PERMANENT CHANGES IN THE LAW.

- THE PHASE-OUT OF PERCENTAGE DEPLETION ALLOWANCES ALONE WOULD ADD $890 MILLION TO TAXABLE INCOME OF COAL COMPANIES IN 1990, THE FIRST YEAR PERCENTAGE DEPLETION IS FULLY PHASED OUT.

- COAL COMPANIES WOULD ALSO BEAR ADDITIONAL TAX BURDENS DUE TO EXCESS DEPRECIATION RECAPTURE OF $390 MILLION. REPEAL OF THE INVESTMENT TAX CREDIT WILL COST COAL COMPANIES $820 MILLION OVER THE NEXT FIVE YEARS.

WHILE THE 62% TAX INCREASE PROJECTED BY THE PRICE WATERHOUSE STUDY MAY SEEM INORDINATELY HIGH, IT IS LESS THAN THE TAX INCREASE DETERMINED BY A GOVERNMENT-SPONSORED STUDY. IN A REPORT JUST RECENTLY RELEASED, THE ENERGY INFORMATION AGENCY FOUND THAT "THE TAXES OF BOTH THE COAL OPERATIONS OF THE TWENTY-FOUR MAJOR ENERGY PRODUCERS AND A SAMPLE OF 7 MAJOR INDEPENDENT PRODUCERS WOULD INCREASE SUBSTANTIALLY RELATIVE TO CURRENT LAW -- BY 81 PERCENT" FOR THE MAJORS AND "49 PERCENT" FOR THE INDEPENDENTS (ANALYSIS OF THE IMPACTS OF THE PRESIDENT'S TAX PROPOSAL ON MAJOR SECTORS OF THE ENERGY INDUSTRY,) THE ENERGY INFORMATION ADMINISTRATION, AUGUST 1985, P. VII).

THE PROPOSALS OF THE ADMINISTRATION WOULD ADVERSELY IMPACT MOST CAPITAL-INTENSIVE INDUSTRIES, BUT IT WOULD HIT COAL MINING, ONE OF THE MOST CAPITAL-INTENSIVE OF INDUSTRIES ESPECIALLY HARD, BECAUSE OF THE LOSS OF PERCENTAGE DEPLETION. SPECIFICALLY, IT WOULD HIT THE COAL PRODUCER HARDEST OF ALL BY THE ADDED LOSS OF CAPITAL GAINS TREATMENT FOR COAL ROYALTIES, THE TOTAL LOSS OF ACCRUAL OF RECLAMATION RESERVES, AND THE INCLUSION OF CERTAIN MINING INCENTIVES AS PREFERENCE ITEMS UNDER THE PROPOSED ALTERNATIVE MINIMUM TAX. FINALLY, THE PROPOSED HIGHER TAXATION FOR BLACK LUNG BENEFITS AND WORKMEN'S COMPENSATION WOULD RESULT IN HIGHER COAL COSTS AND THEREFORE, ADDED COSTS TO THE CONSUMER. THIS IS HARSH TREATMENT TO BOTH THE EMPLOYER AND THE EMPLOYEES OF A STRUGGLING INDUSTRY AS WELL AS ALL OF US PAYING HIGHER UTILITY BILLS.

MAJOR TAX REFORM MUST NOT BE ACCOMPLISHED IF IT CONTAINS SUCH A SERIOUS DISRUPTION TO THE COAL INDUSTRY. EVERY PROVISION IN THE TAX CODE WAS ENACTED TO ACHIEVE CERTAIN DESIRABLE OBJECTIVES IN OUR

COMPLEX ECONOMY, ALLOW ME TO CITE ONE ESPECIALLY IMPORTANT INSTANCE.

COAL IS AN ESSENTIAL INGREDIENT IN OUR NATIONAL SECURITY PROGRAM. IMPORTED OIL HAS PROVED TO BE AN UNRELIABLE AND DISRUPTIVE SOURCE. OUR OWN RESERVES OF OIL AND NATURAL GAS ARE LIMITED. COAL REPRESENTS OVER 80% OF OUR COUNTRY'S FUEL RESERVES, AND IS VITAL TO OUR NATION.

IN THE LAST TEN YEARS, COAL CONSUMPTION HAS INCREASED BY 41% WHILE TOTAL ENERGY DEMAND HAS GROWN VERY LITTLE. AS A RESULT, COAL'S SHARE OF NATIONAL ENERGY CONSUMPTION HAS GROWN FROM 18% TO 23%. COAL'S SHARE OF ELECTRICITY GENERATION, WHERE IMPORTED OIL HAS BEEN VIRTUALLY DISPLACED, HAS GROWN FROM 44% TO 56%. THE PRIMARY CAUSE HAS BEEN COAL'S ABILITY TO COMPETE WITH OTHER FORMS OF ENERGY, BOTH DOMESTIC AND IMPORTED.

YET, WHILE INTANGIBLE DRILLING COSTS FOR OIL AND GAS HAVE BEEN APPROPRIATELY RETAINED IN THE ADMINISTRATION'S PROPOSAL, THAT INGREDIENT OF THE TAX CODE WHICH CONTRIBUTES MOST TO COAL'S COMPETITIVE POSTURE, PERCENTAGE DEPLETION, IS SLATED FOR ELIMINATION. THE PROBLEM WITH OIL AND GAS IS TO FIND IT. ONCE FOUND, THERE IS A FINITE EXPENSE IN PRODUCING AND MARKETING OIL AND GAS. ACCORDINGLY, MAINTAINING FAVORABLE TAX TREATMENT FOR INTANGIBLE DRILLING COSTS IS AN APPROPRIATE INCENTIVE FOR DOMESTIC EXPLORATION TO HELP AMERICA'S DRIVE FOR ENERGY INDEPENDENCE.

WITH COAL, THE PROBLEM IS NOT EXPLORING FOR IT. THE PROBLEM IS PRODUCING COAL AT A COMPETITIVE COST AND DESPITE HIGH RAIL RATES AND THE COSTS OF EXTENSIVE GOVERNMENT REGULATIONS TO BE ABLE TO MARKET THE PRODUCT AND THEREBY LESSEN OUR DEPENDENCE ON IMPORTED OIL. NO

SINGLE CHANGE IN THE TAX CODE WOULD MORE DAMAGE THE ECONOMICS OF PRODUCING COAL THAN THE ELIMINATION OF PERCENTAGE DEPLETION. THAT CHANGE WOULD RUN COUNTER TO THE NATION'S BASIC WELL-BEING.

IN ADDITION TO CONTRIBUTING TO AMERICA'S DRIVE TO ENERGY INDEPENDENCE, COAL CONTRIBUTES POSITIVELY TO OUR EVER-WORSENING BALANCE OF PAYMENTS PROBLEM. WE EXPORTED 81 MILLION TONS IN 1984, CONTRIBUTING OVER $4 BILLION DOLLARS TO THE POSITIVE SIDE OF THE U.S. BALANCE OF PAYMENTS.

WE ARE SEVERELY HINDERED IN COMPETING EFFECTIVELY IN THE FOREIGN STEAM COAL MARKET BY THE STRONG DOLLAR, HIGH INLAND RAIL RATES AND HIGH REGULATORY COSTS IN THIS COUNTRY. IN FACT, WE HAVE DIFFICULTY COMPETING WITH FOREIGN COAL IN SOME REGIONS OF OUR OWN COUNTRY. RIGHT NOW, FOREIGN COAL IS BEING IMPORTED ON THE GULF COAST AT FIVE TO SEVEN DOLLARS CHEAPER THAN OUR COAL CAN BE MINED AND TRANSPORTED DOWN FROM APPALACHIA.

LOSS OF PERCENTAGE DEPLETION WOULD STRIKE THE MOST SEVERE BLOW TO THE COAL INDUSTRY OF ALL THE PROPOSALS.

RICHARD TRUMKA, PRESIDENT OF THE UNITED MINE WORKERS OF AMERICA, DECLARED IN A RECENT INTERVIEW (AND I QUOTE):

> "IF THE DEPLETION ALLOWANCE IS REMOVED, THE PRICE OF DOMESTIC COAL WILL GO UP AND MORE AND MORE IMPORTS WILL BE SOUGHT BY OUR DOMESTIC CUSTOMERS, THUS RESULTING IN GREATER UNEMPLOYMENT HERE AT HOME. THE DEPLETION ISSUE, YOU SEE, AFFECTS EACH OF US DIRECTLY.

THE SECRETARY OF THE TREASURY OF THE UNITED STATES HAS SAID THE UNEMPLOYED CAN FIND JOBS ELSEWHERE. WELL, I SAY YOU CAN ALWAYS WORK AT WENDY'S."

PERCENTAGE DEPLETION IS ONE OF THE MOST MISUNDERSTOOD PROVISIONS OF THE TAX CODE. IT IS OFTEN CITED AS ONE OF THE MAJOR SO-CALLED "LOOPHOLES" YET, IT CAN BE JUSTIFIED BY SIMPLY COMPARING IT TO DEPRECIATION FOR BUILDINGS AND EQUIPMENT. THERE IS AN ANALYTICALLY SOUND ANALOGY BETWEEN PERCENTAGE DEPLETION FOR MINERALS AND DEPRECIATION FOR REPRODUCEABLE ASSETS.

DEPRECIATION OR "CAPITAL CONSUMPTION CHARGES" ARE SET ASIDE BY THE OWNER OF AN ASSET TO BUILD A FUND TO REPLACE THE ASSET ONCE IT HAS BEEN CONSUMED. ECONOMIC PRINCIPLE IS THAT CHARGES SHOULD JUST COVER REPLACING THE ASSET, AND OTHER THINGS EQUAL, NEITHER ADDING TO NOR SUBTRACTING FROM THE CAPITAL STOCK OVER TIME. DEPRECIATION APPLIES TO REPLACEABLE ASSETS SUCH AS BUILDINGS, MACHINES, ETC. -- ITEMS THAT CAN BE REPLACED AT THE SAME REAL COST IN THE FUTURE AFTER THEY ARE USED UP. LEAVING ASIDE THE DISTORTIONS CAUSED BY PRICE INFLATION, TECHNOLOGICAL CHANGE, ETC., IT IS GENERALLY SET TO RECOUP THE INITIAL COST (OR VALUE) OF THE ASSETS, NO MORE AND NO LESS.

DEPLETION ON THE OTHER HAND APPLIES TO NON-REPRODUCEABLE OR WASTING CAPITAL ASSETS SUCH AS FUEL AND NON-FUEL MINERALS AND SERVES THE SAME FUNCTION AS DEPRECIATION FOR RENEWABLE CAPITAL ASSETS. UNLIKE THE CONSUMPTION OF AN ASSET THAT CAN BE REPLACED AT THE SAME REAL COST AT THE END OF ITS USEFUL LIFE, THE REAL COST OF FUEL MINERALS IN THE FUTURE IS GREATER THAN IN THE PRESENT. ECONOMIC THEORY SAYS THE LONG-RUN SUPPLY CURVE FOR NON-REPRODUCEABLE ASSETS SUCH AS

MINERALS SLOPES UPWARD, MEANING IT GETS MORE EXPENSIVE TO BRING THE NEXT RESERVE ON-LINE. THE ECONOMICS OF MINERAL EXTRACTION ARE SUCH THAT YOU MINE (OR DRILL) THE MOST ECONOMICAL RESERVES FIRST AND THEN CONTINUE INTO HIGHER COST RESERVES.

IF DEPLETION WERE SET ON THE SAME BASIS AS DEPRECIATION, THE ECONOMY COULD NOT REPLACE THE CAPITAL STOCK REPRESENTED IN MINERAL PRODUCTION BECAUSE REAL COSTS INCREASE OVER TIME. IT FOLLOWS THEN THAT DISINVESTMENT WOULD OCCUR OVER TIME IF DEPLETION WERE LIMITED TO THE INITIAL COST OF A RESERVE. HENCE, DEPLETION CHARGES MUST NOT ONLY BE SUFFICIENT TO REPLACE THE INITIAL CAPITAL, BUT MUST CARRY AN ADDITIONAL CHARGE DUE TO THE UNIQUENESS OF MINERAL RESOURCE ECONOMICS.

THE RECORD WILL SHOW THAT THE COAL INDUSTRY, AS A GROUP, DID NOT SEARCH OUT SO-CALLED PREFERENCES TO REDUCE ITS TAX LIABILITY. WHILE THE INDUSTRY MUST ACCEPT THE NORMAL RISKS OF THE MARKETPLACE, IT IS DIFFICULT TO BEAR THE LOSS OF POSITIVE TAX PROVISIONS, GRANTED LONG AGO BY THE CONGRESS AND TAKEN INTO ACCOUNT BY THE INDUSTRY IN ITS LONG-RANGE FINANCIAL PROJECTIONS.

SPECIFIC TAXES AND SET FEES CURRENTLY EQUAL HALF THE GROSS REVENUE FROM A COAL OPERATION. BEFORE A PRODUCER CAN THINK IN TERMS OF ANY PROFITS THAT MIGHT BE REALIZED, THE COAL PRODUCER:

- MUST PAY THE LANDOWNER A ROYALTY, IN THE CASE OF FEDERAL COAL LANDS AS MUCH AS 12-1/2 PERCENT, ON THE COAL PRODUCED UNLESS HE HAS TIED UP HIS OWN CAPITAL IN OWNERSHIP OF COAL IN PLACE.

- MAY HAVE TO PAY ROYALTIES OF AROUND 8% (12-1/2% IN THE CASE OF FEDERAL LEASES) OF THE SELLING PRICE.

- MUST PAY THE STATE A SEVERANCE OR PRODUCTION TAX RANGING FROM 3-1/2 TO 5% OF THE GROSS SELLING PRICE FOR EASTERN COAL TO AS MUCH AS 30% IN THE STATE OF MONTANA.

- MUST PAY FROM 1% TO 3% OF THE SELLING PRICE TO RECLAIM ABANDONED MINES FOR WHICH IN MANY CASES THE CURRENT COAL PRODUCER HAD NO DIRECT RESPONSIBILITY.

- MUST PAY AS MUCH AS 4% OF THE GROSS SELLING PRICE TO FUND THE BLACK LUNG RESERVE FOR EMPLOYEES THAT ARE MAINLY NOT HIS OWN. AND THE ADMINISTRATION IS NOW PROPOSING TO RAISE THAT TAX BY 50%, TO AN ANNUAL INDUSTRY TOTAL WHICH ACTUALLY WOULD EXCEED THE PROJECTED INCREASED INCOME TAXES UNDER THE PRESIDENT'S PROPOSAL.

THUS, THE OPERATOR OF A NEW MINE MUST CURRENTLY PAY FROM 12-1/2% TO 49-1/2% OF HIS GROSS REVENUE TO LANDOWNERS AND GOVERNMENTAL AUTHORITIES BEFORE HE CAN BEGIN TO PAY HIS EMPLOYEES, HIS SUPPLIERS, HIS BANK, AND HOPEFULLY, IF THERE IS ANYTHING LEFT AFTER INCOME TAXES, HIS SHAREHOLDERS. IN SHORT, ELIMINATION OF THE COAL PERCENTAGE DEPLETION ALLOWANCE, COUPLED WITH ELIMINATION OF CAPITAL GAINS RATE

ON COAL ROYALTIES AND OTHER PROPOSALS HARMFUL TO THE COAL INDUSTRY, WILL CRIPPLE THE DEVELOPMENT OF AMERICA'S GREATEST FUEL RESOURCE.

MOST OF THE COAL PRODUCED IN THE UNITED STATES IS SOLD UNDER LONG-TERM CONTRACTS. THESE CONTRACTS MAY PROVIDE ESCALATION CLAUSES FOR INCREASED COSTS OF PRECISELY MEASUREABLE ITEMS SUCH AS LABOR, MATERIALS, SEVERANCE TAXES, ETC. HOWEVER, THEY DO NOT PROVIDE ESCALATORS FOR INCREASES IN INCOME TAXES. HENCE, UNTIL NEW CONTRACTS CAN BE NEGOTIATED, THE COAL PRODUCER MUST "EAT" THE INCREASES IN TAXES. DUE TO THE MAGNITUDE OF THE INCREASE, AS PROJECTED BY BOTH THE ENERGY INFORMATION ADMINISTRATION AND THE PRICE WATERHOUSE STUDY, MANY OPERATORS WILL BE THROWN INTO A LOSS POSITION.

HOW MUCH CAN ONE EXPECT THE PRICE OF COAL TO RISE AS A RESULT OF THE PRESIDENT'S PROPOSAL WHEN NEW CONTRACTS ARE NEGOTIATED? INTERESTINGLY, THE GOVERNMENT-SPONSORED STUDY PREDICTS AN INCREASE OF 4.7 PERCENT BY 1990 AS THE DIRECT RESULT OF THE PROPOSED TAX INCREASE. THIS, OF COURSE, ASSUMES THE MARKET AT THAT TIME CAN ABSORB ANY INCREASE. EXTERNAL INFLUENCES SUCH AS THE PRICE OF OIL AND GENERAL ECONOMIC CONDITIONS MAY MAKE OUR INDUSTRY "EAT" THE INCREASE.

FRANKLY, WE DO NOT ACCEPT THE THEORY THAT THE PRESIDENT'S PROPOSAL WILL RESULT IN AN OVERALL BENEFIT BY ASSUMING THAT CAPITAL AND LABOR WILL BE DIRECTED INTO MORE PRODUCTIVE CHANNELS SUCH AS SERVICE INDUSTRIES. YOU CANNOT BURN COMPUTERS IN A UTILITY BOILER, AND FEW COAL MINERS CAN BE TRAINED TO BECOME ELECTRONIC SPECIALISTS. IT IS ENTIRELY WRONG TO CRIPPLE THOSE CAPITAL-INTENSIVE

INDUSTRIES, LED BY MINING, WHICH ARE THE BACKBONE OF OUR ECONOMY, AND WHICH HAVE PROVEN TO BE LIFESAVING DURING NATIONAL EMERGENCIES SUCH AS THE OIL CRISIS OF THE SEVENTIES AND EARLY EIGHTIES.

THANK YOU FOR THE OPPORTUNITY TO PLACE THESE FACTS ON THE RECORD.

EXECUTIVE SUMMARY

The Economic Impact
# of the
President's Tax Reform Proposals
on the
Coal Industry

A Report to the National Coal Association

Price Waterhouse
September, 1985

EXECUTIVE SUMMARY

The coal industry will face higher taxes under the President's Tax Proposals for Fairness, Growth and Simplicity (May 1985). This report to the National Coal Association quantifies the short and long-term effects of the President's Tax Proposals by analyzing both the mining specific and the general corporate tax proposals which will impact the U.S. coal industry. The findings of this report are based, in large part, on survey data collected by Price Waterhouse representing nearly 50 percent of U.S. coal production. Results are weighted to represent the entire coal industry.

The President's Tax Proposals will require the coal industry to pay more than $1 billion in additional federal income taxes over the next five years.

The direct impact of the President's Tax Proposals is very large. Over the first five years, coal industry taxes will be raised by over $1 billion. This amount represents a 45.4 percent increase in tax liability as compared to current law over the same time period. In 1990, the projected tax liability of $800 million under the President's Tax Proposals will represent a 67.6 percent increase in taxes as compared to current law.

Transition rules meant to ameliorate the impact of any increase in tax liability under the President's Tax Proposals fall short of making an effective transition. The increased taxes during year 1 of the proposed changes would be nearly as great as those in year 4. The table below provides a five year summary of the projected changes in coal company taxation due to the President's Tax Proposals.

PROJECTED TAX LIABILITIES - PRESENT AND PROPOSED LAW

U.S. COAL INDUSTRY - 1985-1990

($ millions)

	Current Law	Proposed Law	Difference
1985	422.6	N.A.	N.A.
1986	443.2	623.0	179.8
1987	430.7	535.2	104.5
1988	427.5	623.2	195.7
1989	431.6	635.0	203.4
1990	470.4	788.4	318.0
1986-1990	2,203.4	3,204.8	1,001.4

NOTE: Totals may not add due to rounding.

Historically, percentage depletion has played a major role in the development and production of domestic coal reserves.

The debate over the appropriate tax treatment for the depletion of coal reserves dates back to the inception of the income tax code in 1913. Since the first "code" there has always been recognition of the fact that a "depletion allowance" was necessary. The evolution of Congressional thinking and policy with respect to depletion for coal reached its apex in 1951 when Congress established a 10% percentage depletion allowance for coal. Percentage depletion provisions, as they apply to the coal industry, have remained largely unchanged since 1951. The percentage depletion allowance has played a significant role in the development of domestic coal reserves.

Repeal of Percentage Depletion will cost the coal industry in excess of $900 Million in additional tax liability.

Several provisions of the President's Tax Proposals have substantial impacts on the coal industry (see Table below). In fact, when one considers only those provisions which adversely affect the coal industry, the cumulative increase in taxes paid over the next 5 years is nearly $2 billion. The proposals with the most severe economic impact over the next 5 years are: repeal of percentage depletion; repeal of the investment tax credit; and the recapture of windfall benefit due to excess depreciation.

This $2 billion additional tax liability is reduced to a net level of $1 billion when the favorable provisions are considered, most notably the reduction in the corporate tax rate from 46 percent to 33 percent. Still, $904.9 million of the nearly $1 billion in additional taxes is directly attributable to the repeal of percentage depletion, a provision which only applies to the extractive industries.

While individual companies may be greatly affected by other provisions such as the proposed treatment of royalty income from unrelated parties or the change from the corporate "add-on" minimum tax to an alternative minimum tax, these provisions do not appear to burden the industry as a whole to the same degree as the repeal of percentage depletion.

SUMMARY OF PROJECTED FIVE-YEAR CHANGES IN COAL COMPANY TAX LIABILITIES DUE TO THE PRESIDENT'S PROPOSALS

($ millions)

Provision	1986-1990
Change in Depreciation Allowance	$ 1.1
Repeal of Percentage Depletion	904.9
Dividends Paid Deduction	-34.2
Change in Treatment of Capital Gain on Deprecible Assets	12.4
Change in Treatment of Royalty Income	38.1
Decrease in Corporate Tax Rate	-909.2
Recapture of Windfall Benefit due to Excess Depreciation	217.3
Repeal of Investment Tax Credit	820.1
Change in Corporate Minimum Tax	-46.9
TOTAL DIFFERENCES	$1,001.4

Note: Details may not add to totals due to rounding.

Coal price increases necessitated by implementation of the President's Tax proposals will translate into a 29-million-ton reduction in annual domestic coal production, further reductions in coal employment and increased reliance on foreign sources of coal required to meet anticipated demand.

This study includes the measurement of the long-run impact of tax reform on the cost of producing coal. The long-run analysis is based on a typical expansion of a coal mining operation. An aggregate of the balance sheet information provided by survey respondents is used to specify this typical expansion.

In the long run, higher taxes will require either higher coal prices or a higher rate of return for investors in the coal industry. When the proposed tax reform rules are fully in effect, the real pre-tax rate of return must increase by 23.7 percent. In other words, a coal project must yield a real rate of return of 10.7 percent before tax, when a yield of 8.7 percent would have been sufficient under current law.

The demand for coal is sensitive to changes in price because other fuels may be readily substituted for many uses. The estimates of the potential increase in coal prices and the elasticity of demand for coal suggest that demand could be reduced by as much as 3.3 percent. Assuming constant returns to scale, this demand reduction would mean a decrease of about 29 million tons of annual coal production and about 6,400 coal industry jobs. Thus, the tax increases will translate into increased unemployment in the U.S. coal fields as well as an increased reliance on foreign sources of coal to meet anticipated demand. These adverse impacts on production and employment are, of course, very heavily concentrated in coal mining regions which are often among the least adaptable to other businesses and which already experience disproportionate levels of poverty and unemployment.

Conclusion

It is apparent from the results of this study that the President's Tax Proposals will impose upon the U.S. coal mining industry a tax increase of considerable magnitude resulting in substantial detrimental effects. The study indicates that the effect of this additional income tax liability will be a reduction in coal production; an increase in coal mining related unemployment; a decrease in both internally-generated and externally-generated investment capital; a decrease in exports of U.S. coal; an increase in imports of foreign coal as well as other foreign energy fuels; a loss of a positive $4 billion annually against the balance of payment and a decrease in size of the U.S. coal industry as investors leave the industry searching for an attractive return on their investment.

STATEMENT BY JOHN L. KELLEY, CHAIRMAN, TAX COMMITTEE, AMERICAN IRON ORE ASSOCIATION, CLEVELAND, OH

Mr. Kelley. Mr. Chairman and other distinguished members of the committee, I appreciate this opportunity to appear before you.

My name is John Kelley, vice president of Cleveland Cliffs, Inc. I am also chairman of the tax committee of American Iron Ore Association, which I am representing here today. We are a trade organization representing companies that mine approximately 75 percent of the iron ore that is produced in the United States and Canada.

Regrettably, I must say that I am appearing here in opposition to the President's proposals, in spite of our total agreement with the objectives and our due regard for the tremendous effort that has been expended on this worthy project by dedicated Treasury Department personnel.

Despite the beneficial effects to business in general of such measures as the corporate rate reductions and the dividend-paid deduction, the package offers little comfort to basic industries that must compete internationally. We are convinced that there exists a reasonable likelihood that repeal and reduction of capital formation tax incentives for the manufacturing, basic industry, and mining sectors, even with the beneficial provisions, will force or induce a significant shift of production activity to offshore locations.

The iron ore industry shares a common destiny with the domestic steel industry, because our product can be used only for conversion to iron metal and steel. The common economic plight of these two industries is graphically illustrated in the exhibits attached to our written statement. Even though there has been a resurgence of business activity following the disastrous 1982 year, operating levels in subsequent years, including 1985, have not been high enough to restore our industry to economic vitality. Our future and the future of mining communities remain in serious jeopardy.

It is extremely troubling to us that actual steel imports to date in 1985 are far above the range specified by the 1984 Steel Import Stabilization Act. Without a dramatic reduction in steel imports, cash flow for continued modernization of steel facilities will not materialize. Consequently, any tax legislation that would hinder in any way the rate at which domestic steel industry modernization can occur should be recognized as contrary to the Stabilization Act. We believe the President's proposals would have this effect.

Most of our domestic mining operations are located in the northern regions of two central States. Their proximity to interior steel mills in the United States and Canada is complemented by the avallability of water transportation on the Great Lakes. We cannot serve any other steel-consuming region in the world. In contrast, many foreign producers have expanded their operations, with government assistance, to serve export markets, and the result has been worldwide overcapacity. Certain foreign governments have also preempted the natural laws of economics while promoting social employment and the receipt of U.S. currency, and U.S. industry is paying the price. An overvalued dollar has added another severe dimension to this problem.

Our industry has already been rationalized, and presently we have a huge investment in 11 modern and efficient processing plants. We emphasize the link between these plants and our Nation's consumption of domestic steel products. In short, the level of domestic steel consumption has been so meager in recent years that we have been unable to keep our pellet plants operating at anywhere near designed capacity. We are worried about how long we can hold on in the absence of a dramatic change for the better, and we are concerned for our country if the precipitous shrinkage of our basic steel industry is not abated.

Two of our specific points of opposition to the President's tax package pertain to recommended changes in mine operator incentives; namely, the recommendations to repeal percentage depletion and to treat mine exploration and development expenditures as preference items. We also urge retention of general incentives that stimulate industrial capital investment. We believe the package is fundamentally faulty, because it would have a destabilizing impact on a vital segment of our Nation's economy.

The amount of attention given to tax reform in recent years has been focused primarily on individual taxes and tax shelter abuses. The president's proposals go far beyond these areas of critical need. In so doing, and in an attempt to retain revenue neutrality while substantially lowering rates, the package would be harmful to our Nation's industrial core. Moreover, it is our considered opinion that the proposals are much too broad and comprehensive to be dealt with thoroughly and effectively in one year.

I thank you for your kind attention.

The CHAIRMAN. Thank you.

Mr. Bedell?

[Mr. Kelley's written testimony follows:]

AMERICAN IRON ORE ASSOCIATION

1501 EUCLID AVE · 514 BULKLEY BLDG. · CLEVELAND, OHIO 44115 · 216 241-8261

Statement
of

AMERICAN IRON ORE ASSOCIATION

before the
Committee on Finance

Presented by
John L. Kelley
Chairman, Tax Committee
American Iron Ore Association

Mr. Chairman and other distinguished members of the Committee, I appreciate this opportunity to appear before you.

My name is John Kelley, Vice President of Cleveland-Cliffs Inc. I am also Chairman of the Tax Committee of the American Iron Ore Association, headquartered in Cleveland, Ohio, which I am representing here today. The Association is a trade organization representing companies that mine approximately 75% of the iron ore that is produced in the United States and Canada.

Regrettably, I must say that I am appearing before you in opposition to the President's proposals in spite of our total agreement with its objectives - fairness, growth, and simplicity - and, in addition, our due regard for the many hours of effort that have been expended on this worthy project by dedicated Treasury Department personnel.

Our opposition is easily summarized. The President's proposals could cause the permanent shutdown of a significant part of both the steel and iron ore industries in the United States, two vital industries that today are already in deep, but still reversible, economic trouble. We are convinced that our own exertions to overcome our economic difficulties may be compromised unless key features of the proposals are substantially modified. This could mean demise of the entire package but we believe this consequence, in terms of the long-term national interest, may be for the better, especially considering the degree

SERVING THE IRON ORE INDUSTRY OF UNITED STATES AND CANADA

of controversy over its many key elements that has arisen over the past several weeks. In any event we ask that Congress not go forward with the proposals as they stand.

Despite the beneficial effects to business generally of such measures as the corporate rate reductions and dividend paid deduction, the package offers little comfort to basic industries that must compete internationally. We are convinced there exists a reasonable likelihood that repeal and diminution of capital formation tax incentives for the manufacturing, basic industry, and mining sectors, even with the beneficial items, will force or induce a significant shift in production activity from the United States to offshore locations. An inevitable consequence of such a shift would be a contraction in the market for domestic steel and iron ore production.

The iron ore industry shares a common destiny with the domestic steel industry because the product of our industry can only be used for conversion to iron metal and steel, and it is not economic to transport our domestic ore beyond the Great Lakes area. We believe it is now quite generally known that for many reasons the vital signs in domestic steel have for the past several years been absolutely dismal and that in many respects they continue to deteriorate despite extraordinary efforts of labor, management and government to reverse these trends. The common economic plight of our industry and the domestic steel industry is graphically illustrated in Exhibits I through V attached to this testimony, to which we direct your careful attention. These exhibits depict rather clearly the recent history and present status of iron ore mining in the United States. Our inability to operate at economic levels of operations in recent years is shown as a direct reflection of economic difficulties being experienced by the domestic steel industry. Even though there has been a resurgence of business activity following the disastrous 1982 year, operating levels in subsequent years, including 1985, have not been high enough to restore the industry to economic vitality. This precarious condition will continue unless there is a prompt reversal of the steel import trend presented in Exhibit IV and a restoration of the domestic business to higher operating levels. Our future and the future of mining communities remain in serious jeopardy.

The grave situation confronting the steel industry is further underscored in a decision last summer by a federal bankruptcy judge concerning the financial difficulties of one major domestic steel producer.

This forum does not provide the opportunity to discuss in detail the trends in foreign steel imports; but we do want you to know we are most anxious about the resolution of this horrendous problem, and it is a real worry to us that actual steel imports to date in 1985 are far above the 17.0 to 20.2 percent range specified by the 1984 Steel Import Stabilization Act - about 30 to 53% above to be more exact. We recognize and applaud the herculean task of seeking bilateral agreements with a multitude of foreign governments, but without a dramatic reduction in steel imports, the continued modernization that is needed so desperately in the U.S. steel industry will soon begin to wither, causing serious new problems. Consequently, tax legislation that would hinder in any way the rate at which U.S. steel industry modernization can occur should be recognized as contrary to the Steel Import Stabilization Act. We believe the President's tax proposals will have this effect.

The United States iron ore industry is located almost exclusively in two states, Michigan and Minnesota. Its proximity to interior steel plants in the United States and Canada is complemented by the availability of water transportation on the Great Lakes. Various economic and other restrictive factors prevent our industry from serving any other steel consuming region in the world, and so we have no choice but to serve the markets we have served for more than 130 years. In contrast, many foreign producers of both iron ore and steel with government assistance have expanded their operations to serve export markets, and there has resulted a large overcapacity throughout the world. The motivation of certain foreign governments to generate social employment and obtain U.S. dollars has often tended to preempt the natural laws of economics, and U.S. industry is paying the price. An overvalued dollar has added another severe dimension to the problem.

Over the past decade nearly thirty of our less efficient iron ore mines and plants have been permanently closed. Today, our entire domestic capability rests with only eleven efficient pellet plants that are listed in Exhibit V plus a few natural ore facilities which account for negligible tonnage.

It is generally recognized that mining is an extremely risky business. Yet, we have recently invested billions of dollars in state-of-the-art pelletizing plants, power generating facilities, modern self-unloading lake vessels, and other infrastructure for domestic trade with the expectation that a reliable and stable U.S. tax system would continue to provide essential incentives to help bring an adequate return on these very long-term fixed investments. Understandably, our expectations were strengthened by enactment of the Mining and Minerals Policy Act of 1970 and the Materials and Minerals Policy Act of 1980, both of which are in support of minerals development and enhanced minerals availability as a matter of national policy. To now be confronted with a proposed tax system change which could bring about results that are directly in conflict with existing minerals policy as enacted by Congress is beyond our ability to understand or reconcile.

In summary, we have recently experienced an abrupt and severe business contraction, and our present economic plight is extremely bleak. We are almost totally dependent upon the United States steel industry, and it would appear that our domestic steel industry, in turn, is almost totally dependent upon manufacturing and construction activities which are carried on in the United States. We are talking about a *domestic* mineral for a *domestic* basic industry which supplies raw materials to *domestic* producers of goods for consumption, but we do not espouse government protection. Fair and lawful trade is our theme with retention of basic industry tax incentives. In addition to the direct jobs that are created by these activities, there are many multiples more created for supplies of other goods and services. It's virtually a house of cards in which the iron ore industry is not visible to ultimate consumers of manufactured goods. This is a major reason why we have placed so much reliance on the minerals policy Acts and on last year's Steel Import Stabilization Act. Indeed, we must assume that the United States Congress and its President are serious and mean what they say when they enact a series of laws over fifteen years, all pointing to an important and consistent policy position. This type of national policy should not be adopted or altered without very thorough, deliberate, consideration.

To carry out our existing national policy it is urgently necessary to provide through our tax system the incentives to domestic industries that continue to be ravaged by economic depression and threatened by foreign dumping and subsidies. The question is not growth or expansion; it is tax stability for long-term survival of vital basic industries.

In addition to meeting national policy objectives, the following additional reasons point out why the existing domestic mining industry's survival for the foreseeable future is of critical importance to the nation and why a shift in tax policy should not be the catalyst of further financial hardship:

* Existing facilities are generally modern and efficient.

* Huge investments are at stake (billions of dollars) coupled with long-term financial obligations to lending institutions.

* Mining families and mining communities are economically locked in.

* Factors of inordinate risk should be acknowledged.

* Domestic sources of supply which provide national security, economic as well as defense, should be assured.

* Government should acknowledge and support industry's continuing self-help efforts in troubled times.

* Utilization of costly, debt-burdened existing power generating facilities that would otherwise remain idle should be encouraged.

* It should be understood that closed, dismantled and abandoned mines cannot be reopened.

* There should be a furtherance of positive relations involving iron ore and steel trade between United States and Canada. (U.S. mines serve Canadian interior mills; Canadian mines serve U.S. coastal mills.)

* Additional balance of payments shortfall should be avoided.

* If present tax incentives or something better were available, existing excess capacity in U.S. mines could constitute an attractive investment to U.S. and Canadian steel operators.

* Retention of tax incentives promotes and helps to provide cash flow for continuation of steel industry modernization programs yet to be completed and for intensified research on both iron ore and steel processing to further their better integration.

* Major domestic consumers of supplies, equipment and other goods and services, including electronic technology applications, would remain in business.

The President's tax proposals as they would affect business and productive capital investment concern us in several ways. As previously mentioned, we certainly subscribe to the principles of fairness, growth, and simplicity. Who wouldn't? But we are convinced that the proposals would not make significant strides toward attaining any of these goals, especially when we reflect on the business tax changes and how those changes would, in the long run, ultimately affect individuals.

Referring now to the specific recommendations in the President's proposals which cause us to conclude that, in the aggregate, the package constitutes a serious threat to the survival of our existing domestic mining and industrial base, we offer the following points of opposition:

The first is the recommended repeal of percentage depletion. This important income tax deduction, which has been available to iron ore for fifty-three years, should be characterized as an equalizer and not a preference when considering world mineral competition and economics. Although its value to United States mining companies has substantially been reduced over the past fifteen years by its treatment under the add-on minimum tax, there is no question that it has been a major contributor to the economic vitality and competitive capability of our domestic mining industry. Cash flow that has been generated from percentage depletion over the years by the iron ore industry has neither been squandered nor held for a rainy day. It has been reinvested in developing new properties, in mineral processing technology and other research, and in modernizing plants with efficient equipment and electronic instrumentation. Continuity of this cash flow is essential.

The second is the recommended treatment of exploration and development as a preference item under the proposed alternative minimum tax. Besides being disappointed that a reform package as comprehensive as the President's does not discard the dual approach to the determination of taxable income, which would rid the Code forever of the tax on business tax deductions, we strenuously object to the inclusion of mineral exploration and development as preference items. First of all, these two types of expenditures are not similar and must be distinguished from each other as they are under existing tax law. Most exploration expenditures do not result in the discovery of economically mineable mineral deposits; and those that do are required to be capitalized as cost of the mineral property under existing law. Development expenditures are incurred solely to facilitate extraction of ore, and they continue throughout the life of the property. Mining cannot continue without incurring ongoing development expenditures, and nothing of value remains when mining is no longer economically feasible. In fact, an exhausted ore body has negative value in that many post-mining costs must be incurred to restore the property to an aesthetically acceptable condition for general, nonmining use.

The third is the recommended repeal of the investment tax credit. We understand this incentive to be of vital importance to many business organizations that we serve. Over the past twenty-plus years when this credit has been repealed or suspended and then restored, there have been strong and convincing indications that investment in machinery and equipment is stimulated by the credit. In addition, it should be understood that the investment tax credit continues to be the key ingredient to many investments and modernizations that are financed by lease arrangements. Lack of financial resources on the part of capital intensive companies in many cases would otherwise prevent these investments.

The fourth is the recommended disqualification for capital gains treatment of dispositions of iron ore reserves through long-term lease arrangements. Although American Iron Ore Association represents the operating companies, these long-term arrangements and their tax treatment are a practical and meaningful element of the industry economics which have made high quality domestic iron ore available to domestic steel consumers.

The fifth is the recommended substitution of CCRS depreciation for ACRS. Although not terribly detrimental when compared to ACRS, we are of the view that the proposal adds a disproportionate amount of complexity without sufficient justification or rationale. We are also not persuaded that there is anything so fundamentally deficient in the ACRS system, which itself represents a recent change of significance. The ACRS system ought to be given more than four years to function before being abolished unless proven to be overwhelmingly defective.

The sixth is the recommended recapture in years 1986 through 1988 of prior years' ACRS depreciation. We consider this recommendation to be a retroactive repeal of law, and the rationale offered to justify it is not realistic or convincing.

The seventh is that, although we subscribe to the notion that all taxpayers having income should pay tax, continuation of a minimum tax theme in which business and personal deductions are taxed as income is conceptually faulty in its approach. Although the Proposals' alternative method is much better than the existing add-on type, this safety net approach of defining taxable income in two different ways cannot truly be characterized as reform. Capital intensive, low income mining companies have experienced a perverse and volatile impact from the deduction-type minimum tax.

While our testimony, for the most part, has dealt with those parts of the proposals which are of significant importance to our Association's members as affected taxpayers, we do feel compelled to comment on certain other aspects which either affect us indirectly or are of serious concern to us. They are:

* The shift of tax burden from individuals and consumer-type enterprise to the low income, capital intensive industrial sector which produces goods that are also available from foreign sources, could result in extensive plant shutdowns for basic industry in the long term. (Although the proposal explicitly anticipates a shift of capital and labor flow on a so-called "free market" basis, we hope the Congress will recognize the danger to the United States in taking this path, considering world circumstances as they exist today.)

* We believe the Treasury estimate of a 1.5% increase in real

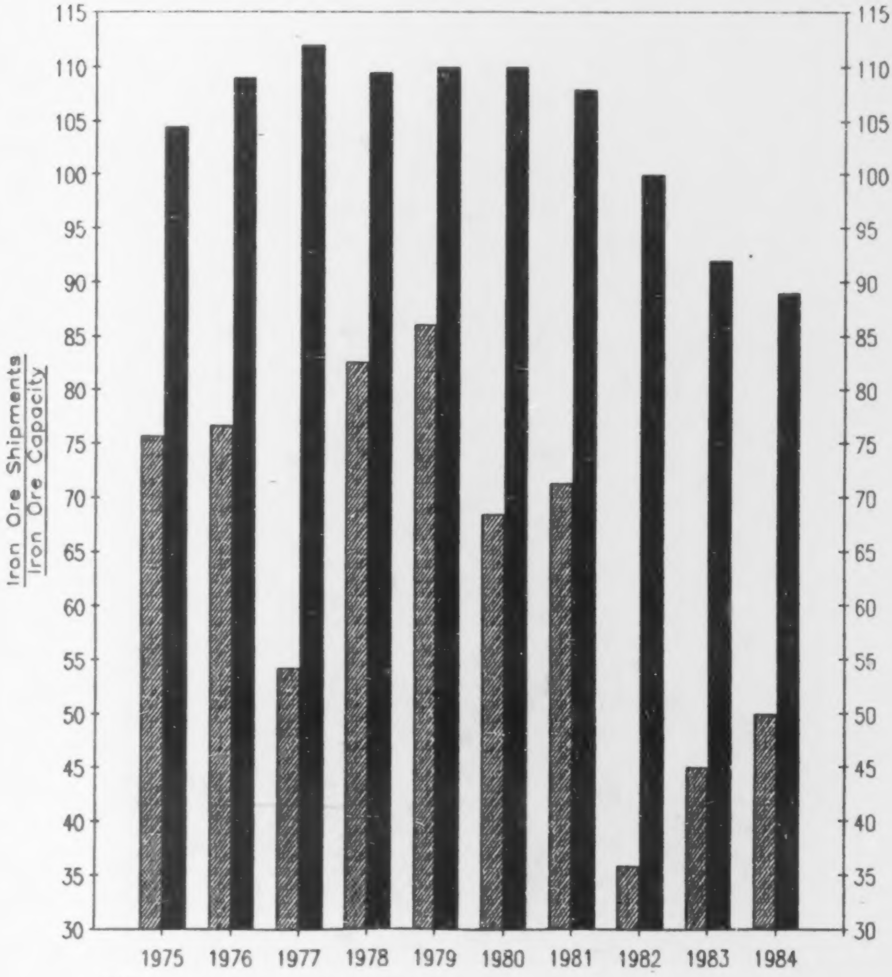
gross national product by 1995 is highly conjectural and, in view of the uncertainty of economists about the proposals' impact, even in the short run, is a very poor reason for upsetting our entire tax system in the manner recommended and subjecting a major portion of basic industry to the threat of extinction in the process.

* Questions about revenue neutrality of the package which were raised by the Congressional Budget Office and others have apparently been put to rest by supplementary recommendations of the Treasury Department, but we are continuing to urge that the issue of federal deficits remain a matter of priority in the Congress and that there be further emphasis on spending curtailments.

Considering the amount of attention that has been given to tax reform in recent years and recognizing that the real focus of concern has related primarily to individual taxes and tax shelter abuses, we believe very strongly that the President's proposals go far beyond the areas of critical need. In so doing and in the attempt to retain revenue neutrality and substantially lower rates, the proposals would be harmful to our country's industrial core. Moreover, it is our considered opinion that the proposals are much too broad and comprehensive for Congress to deal with thoroughly and effectively in one year.

STATEMENT OF AMERICAN IRON ORE ASSOCIATION
BEFORE THE COMMITTEE ON FINANCE
September 26, 1985
EXHIBIT I

United States Iron Ore Shipments vs. Capacity
1975–1984
(millions of gross tons)

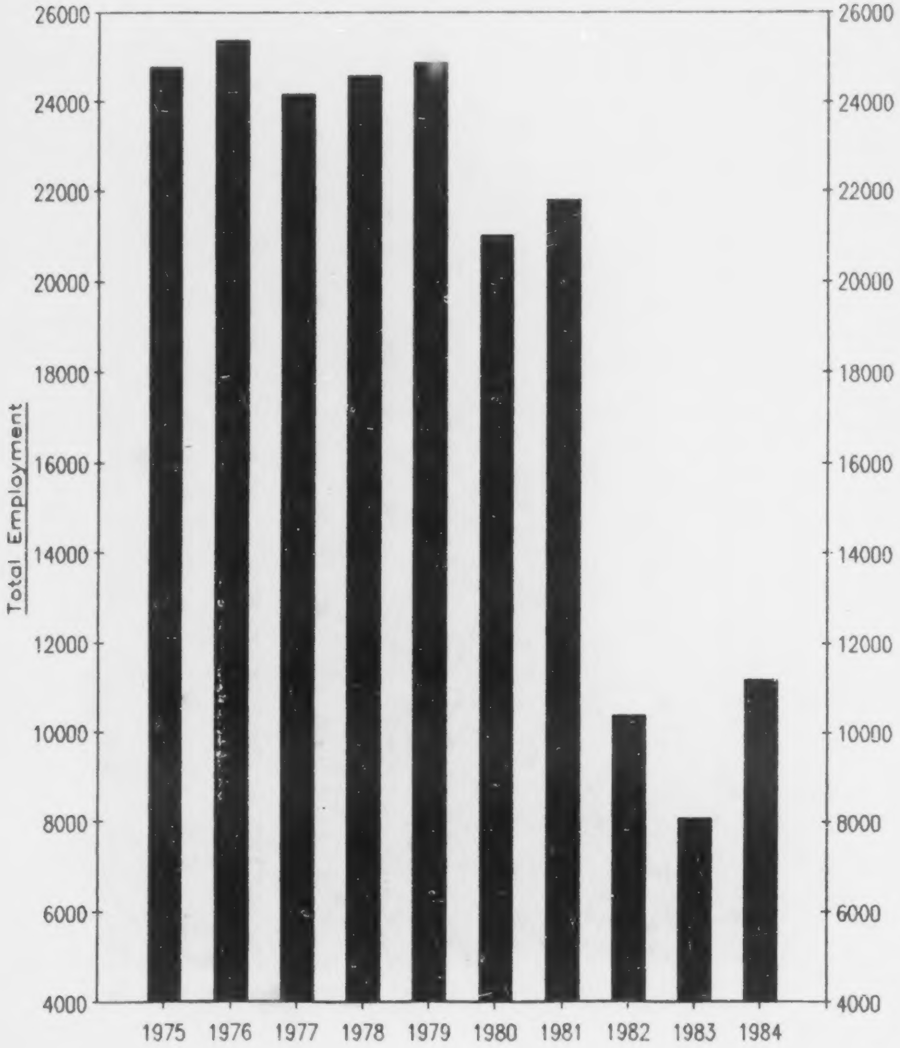


LEGEND: Iron Ore Shipments – Hatched Bar
Iron Ore Capacity – Solid Bar

Source: American Iron Ore Association

STATEMENT OF AMERICAN IRON ORE ASSOCIATION
BEFORE THE COMMITTEE ON FINANCE
September 26, 1985
EXHIBIT II

United States Iron Ore Industry Employment
1975-1984

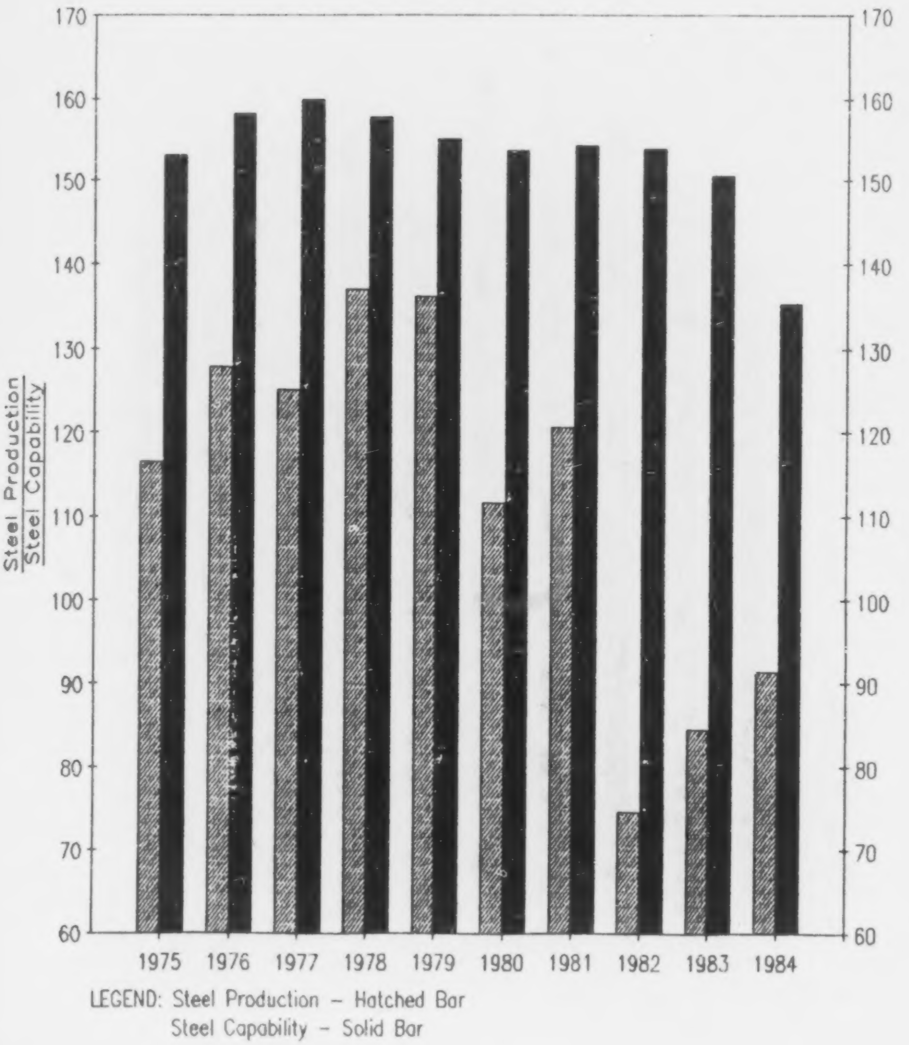


Source: American Iron Ore Association

STATEMENT OF AMERICAN IRON ORE ASSOCIATION
BEFORE THE COMMITTEE ON FINANCE
September 26, 1985
EXHIBIT III

United States Steel Production vs. Capability

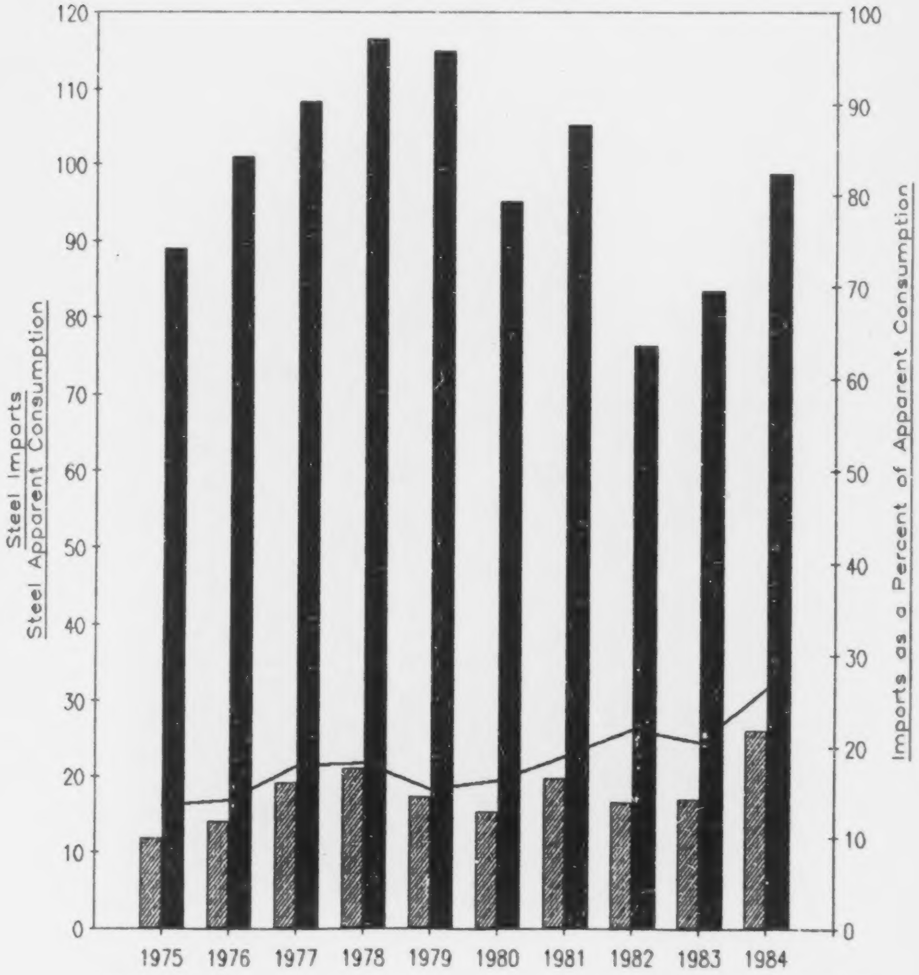
1975–1984
(millions of net tons)



Source: American Iron and Steel Institute

STATEMENT OF AMERICAN IRON ORE ASSOCIATION
BEFORE THE COMMITTEE ON FINANCE
September 26, 1985
EXHIBIT IV

United States Steel Apparent Consumption vs. Imports
1975–1984
(millions of net tons)



LEGEND: Steel Imports – Hatched Bar Steel Apparent Consumption – Solid Bar
Steel Imports as a Percent of Apparent Consumption – Solid Line

Source: American Iron and Steel Institute

STATEMENT OF AMERICAN IRON ORE ASSOCIATION
BEFORE THE COMMITTEE ON FINANCE
September 26, 1985
EXHIBIT V

EXISTING IRON ORE PELLETIZING FACILITIES LOCATED IN THE UNITED STATES

Plants Operated by Members of
American Iron Ore Association
By State

MINE NAME	ANNUAL CAPACITY IN MILLIONS OF TONS	
MICHIGAN		
Empire	8.0	
Tilden	8.0	
Republic	2.7	(idle since 1981)
MINNESOTA		
National	4.0	
Erie	11.0	
Hibtac	8.1	
Eveleth	6.0	
Minorca	2.6	
Reserve	8.2	
MISSOURI		
Pea Ridge	1.7	
TOTAL CAPACITY	60.3	

Note: There exists one additional pelletizing facility in Minnesota which is not operated by an Association member. Its annual capacity is 18.5 million tons. Also not included above is the Butler plant in Minnesota (annual capacity 2.7 million tons) which was permanently closed at the end of June, 1985.

Source: American Iron Ore Association

STATEMENT BY DENNIS P. BEDELL, CHAIRMAN, TAX COMMITTEE, AMERICAN MINING CONGRESS, WASHINGTON, DC

Mr. BEDELL. Thank you, Mr. Chairman.

I am Dennis Bedell, a member of the law firm of Miller Chevalier. I am also chairman of the tax committee of the American Mining Congress, and it is in that capacity I appear before you this morning.

The American Mining Congress appreciates this opportunity to present its views to the committee.

It is no secret that the recession of recent years has severely impacted the domestic mining industry. One need only look at the metal mining segment of the industry to see how dramatic it has been. Since 1980 the size of that segment of the industry has shrunk to two-thirds of its former amount; employment has been cut in half.

Many minerals are internationally traded commodities, and so it is in the international marketplace that the domestic industry must compete. This is increasingly difficult, because many of the foreign competitors are not burdened by costs such as those imposed on the domestic industry through environmental controls and through Government restrictions. Many of them are controlled by foreign governments or subsidized by their foreign governments, and so they don't have to worry about considerations such as whether there are profits from the sale of their minarne commodity or indeed whether the selling price even covers their costs, because other concerns such as obtaining foreign exchange are of greater importance.

With this situation and the precarious state of the domestic mining industry, it is not surprising that the President's Tax Reform Program is of significant concern to the mining industry.

To assist the mining industry and the Congress in evaluating the impact of the President's program on the mining industry, the firm of Arthur D. Little evaluated the President's program in its totality. I would like to just briefly summarize the salient findings of that study of the impact of the proposals on the industry for the committee.

First, A.D. Little found that the President's program will more severely impact the mining industry than any other segment of U.S. industry. This is in large part a function of the fact that not only, as a capital-intensive industry, is the mining industry hurt by the loss of the investment tax credit and the cutback in the depreciation system, but in addition, the industry is hurt by the repeal of the percentage depletion allowance, which is the particular capital allowance long provided for the natural resource sector.

Second, the level of taxation resulting under the President's program would increase about 50 percent for the mining industry, which would lead to a reduction in the level of investment that would flow into the mining industry of approximately 15 percent. And Arthur D. Little concluded that would eventually lead to a 20-percent reduction in output from the domestic industry. That 20-percent reduction in output would cause a loss of 380,000 jobs in the mining industry and the allied industries that serve and assist the mining industry. It also would lead to an increase in imports of mineral commodities of approximately $10 billion a year.

On pages 15 and 16 of our prepared statement there is a quote from a Bureau of Mines study with respect to the effect of repeal of the depletion allowance for copper, but it has much broader implications in what it says. Stated very simply, that study concluded that the costs resulting from loss of percentage depletion—what it would cause in terms of the loss and decrease in mining income, employment, the costs associated with that, as well as the loss in tax revenues and increased imports—would more than offset any revenue gain, any increase in corporate income taxes, that would result from the repeal of the depletion allowance.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you, sir.

Mr. Swenson.

[Mr. Bedell's written testimony follows:]

AMERICAN
MINING
CONGRESS
FOUNDED 1897
SUITE 300
1920 N STREET NW
WASHINGTON
DC 20036
202/861•2800
TWX 710•822•0126
J. ALLEN OVERTON JR.
PRESIDENT

STATEMENT

OF THE

AMERICAN MINING CONGRESS

TO THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

BY

DENNIS P. BEDELL

CHAIRMAN, AMERICAN MINING CONGRESS TAX COMMITTEE

SEPTEMBER 26, 1985

Mr. Chairman and Members of the Committee:

My name is Dennis P. Bedell. I am Chairman of the Tax Committee of the American Mining Congress and a member of the Washington, D.C. law firm of Miller & Chevalier, Chartered.

I am appearing before you today on behalf of the American Mining Congress. We appreciate this opportunity to testify with respect to the President's tax proposals.

The American Mining Congress is an industry association representing all segments of the mining industry. It is composed of (1) U.S. companies that produce most of the Nation's metals, coal and industrial and agricultural minerals; (2) companies that manufacture mining and mineral processing machinery, equipment and supplies; and (3) engineering and consulting firms and financial institutions that serve the mining industry.

A federal tax system that recognizes the importance of the U.S. mining industry to the Nation's security and economic well-being is essential to the industry's survival. Not only, however, does the existing tax system fail the Nation by not encouraging the investment necessary for a strong domestic mining industry, but even more importantly, the major tax revision proposals of the President being considered by this Committee would magnify that failure and in so doing would severely damage the industry.

The extent of the damage to the domestic mining industry and, accordingly, to the United States that would result from the President's tax revision proposals is set forth in a study prepared by Arthur D. Little, Inc. and Jones, Day, Reavis & Pogue at the request of the American Mining Congress. The study, entitled Impact of the President's Tax Reform Proposals on the United States Mining Industry, concludes that the President's proposals, if enacted, would severely damage the already weakened U.S. mining industry. Important results of the study include the following--

- The President's tax proposals may affect the mining industry more severely than any other business area.
- Tax liabilities would increase by about 50% for profitable firms, perhaps the largest increase in any business sector.
- Cash flow for typical firms would decline by about 6% and total investment in the industry would decline by about 15%.

- Rates of return on mining investments would decrease by 10 to 20%, while returns in many other industries would increase.
- The mining and support industries would lose over 380,000 jobs, many in regions offering few other employment opportunities.
- The proposed tax program would erode American mining self-sufficiency and increase dependence on foreign suppliers.
- The removal of established tax incentives would place U.S. mining firms at a further disadvantage to foreign producers.
- Domestic mining companies generally cannot pass increased costs--including taxes--along to their customers because prices are set in the world market.
- Over the past few years, mining companies have been besieged by growing international competition, the high dollar and weak product demand.
- Foreign producers, especially in developing countries, have increased production, in many cases based on their needs for foreign exchange and employment rather than on the free-market economics of supply and demand. Mining firms have very little control over prices.
- The proposed law would discourage new investment immediately and have a major impact on mining output over the next ten years.
- The consequences of the proposal would contradict both the Mining and Minerals Policy Act of 1970 and the National Critical Materials Act of 1984, both of which support mining self-sufficiency.

The Executive Summary of the study is included as Exhibit A.

The American Mining Congress strongly believes that certain elements of a tax system are of critical importance in encouraging the needed investment of capital in the high risk mining industry. They include the percentage depletion allowance, the deduction for mine exploration and mine development costs, a stimulative capital cost recovery system, such as is provided by the combination of the investment tax credit and ACRS depreciation, and capital gains treatment for coal and iron ore royalties. These elements provide the requisite incentive for the industry to survive and grow and must be preserved and strengthened, not eliminated or curtailed.

Overview

Historically, our federal income tax system has recognized the fundamental and essential role of this country's mining industry. Mining's importance to our economic and national security has long been acknowledged through provisions such as the percentage depletion allowance and the deduction for mineral exploration and development expenditures. These and other critical provisions involving capital cost recovery have helped to foster an assured availability of raw materials for manufacturing while generating needed cash flow for the mining industry. The roots of our tax system reflect the fact that exhausted mines must be replaced with deposits which are often more difficult and expensive to discover and to process into an acceptable standard of product quality. Moreover, without meaningful tax incentives that reflect the unique nature of mining, there is little likelihood that private investors would be willing to undertake the inordinate risk that is an inherent aspect of the business.

During the past decade and a half, however, we have witnessed a gradual, though indirect, erosion of the U.S. tax structure affecting the mining industry. This erosion has been reflected primarily in the form of an add-on corporate minimum tax which penalizes mining enterprise in its sweep to stifle tax shelter activities. If not corrected, the present system could soon strip away completely this country's ability to sustain and support a vigorous, dependable, and competitive mining industry of any significant size. We believe that this erosion reflects misdirection of tax policy in recent times, and we are even more alarmed by the President's proposals to further reduce or eliminate mining industry tax incentives.

Over recent years as the tax burden on U.S. mining companies has been increasing, the size of the industry has decreased precipitously. The economic recovery being experienced throughout the country has not found its way to the mining industry. The U.S. metals mining segment, for instance, is presently only two-thirds its 1980 size, and employment has been cut in half. Factors contributing to this trend and the fragile condition of our mining industry include U.S.-supported loans to foreign mining projects and an overvalued currency. Thus, any change in our tax system at this precarious time which would cause private investment in natural resources to become less attractive would certainly have a disastrous and abrupt impact on the severely weakened U.S. industry.

It is now more than ever before imperative for our remaining mining industry to survive and prosper as we face an ever-expanding global economy and severe pressure on prices. Mineral deposits are located throughout the world without regard for national boundaries or forms of government. The only natural differentiation is that, generally, the higher grade and more-easily mineable reserves are now located outside the United States. To enable our own domestic mining industry to compete against producers that are wholly or partially owned, operated, or subsidized by foreign governments, therefore, it is clear that unique and substantial tax system incentives are essential. What is now in place must be retained and, in fact, improved. Without this recognition, we believe it is certain that the U.S. mining industry will dwindle to a position of insignificance in comparison to its fast-developing foreign counterparts.

Natural resource and agricultural endeavors provide the feedstock for all food, fuel, fibers, materials and manufactured products which are needed for human existence. It is not a question of whether to extract or farm. It is, instead, who will extract, who will farm, and where. America was originally blessed with bountiful natural resources, and our private enterprise system with encouragement from an enlightened tax policy provided the means to bring about development of those resources at affordable cost. An efficient and dependable minerals and agricultural production capability had much to do with the prime position of strength and leadership that the United States has occupied for more than two centuries. Now with the world and its economy changing so rapidly -- to a great extent because third world nations are hastening to develop their own natural resources -- our established position is being severely threatened. Under these circumstances, there is valid reason to be alarmed about the direction our standard of living could take in the near future without a viable mining industry of our own.

The mining industry plays a backstage role in society because it is at the foundation of productive activity. It is located in relatively remote areas using only three-tenths of one percent of our land surface, and the general public has little name-brand awareness of mining. These factors may account for the lack of appreciation in this country for mining's contribution to our everyday needs. We are living in a push-button, self-serve era in which it is all too easy to overlook the basic industries that make our daily lives mobile, comfortable, and entertaining. In fact, our fast-track society has developed a very low threshold of tolerance for any disruption of our individual ability to control our own lives, perhaps with too little understanding of or appreciation for the basic industries that make it all possible.

Mining is enormously capital intensive, and most projects take years before production is commenced. In addition to the unique considerations involving each deposit and plant flowscheme design, mining projects also have unusual challenges involving financing and infrastructure necessities. Building or rebuilding a Nation's mining industry calls for decades of effort and huge expenditures. These factors and the importance of having an assured availability of raw material for industry were recognized by Congress in the Mining and Minerals Policy Act of 1970, and subsequently reaffirmed by Congressional and Executive actions, which declare it to be national policy to encourage private enterprise in developing an economically sound domestic mining industry and the orderly development of U.S. mineral resources.

There is no way to reconcile our acknowledged U.S. minerals policy as so expressed with a tax system that does not provide extraordinary encouragement to invest in mining activities, and it is most disconcerting that the President's proposed changes in the tax system which would further penalize the U.S. mining industry internationally are being extolled under the misleading and erroneous label of reform. If these proposals are accepted at face value and enacted without challenge, the chances are slim that a reversal of tax law could occur in time to salvage our already shrunken and jeopardized industry.

Percentage Depletion

The President's tax proposals -- particularly the phasing out of the percentage depletion allowance -- are at cross purposes with the country's stated national minerals policy and would make it increasingly difficult for the financially-pressed domestic mineral industry to produce basic minerals and to explore for and develop new domestic mineral resources.

There is currently intense focus, as evidenced by the enactment of the National Critical Minerals Act of 1984, on questions of domestic minerals availability and the extent of dependence on imported materials.[1] Our Nation's past experience of heavy reliance on imported oil and the consequent effects on the standard of living and conduct of foreign affairs demonstrates the dangerous potential of a similar dependence on foreign sources for hard minerals and should be reason enough to encourage national independence.

---

[1] The National Critical Minerals Act of 1984, Title II of P.L. 98-373, reaffirms that supplies of minerals and materials are vital to the security, economic well-being and industrial capacity of the United States. Specifically, Congressional findings, stated in Section 202(a) of that Act, include the following:

1) the availability of adequate supplies of strategic and critical industrial minerals and materials continues to be essential for national security, economic well-being and industrial production;

2) the United States is increasingly dependent on foreign sources of materials and vulnerable to supply interruption in the case of many of those minerals and materials essential to the Nation's defense and economic well-being;

3) together with increasing import dependence, the Nation's industrial base, including the capacity to process minerals and materials, is deteriorating -- both in terms of facilities and in terms of a trained labor force;

4) research, development and technological innovation, especially related to improved materials and new processing technologies, are important factors which affect our long-term capability for economic

(footnote continued)

The availability and production of minerals, both domestic and foreign, are measurably affected by the system of taxation and its economic impacts on mining in the United States.[2] For example, Congress has long recognized the major impact of federal tax laws that allow a deduction of percentage depletion by this Nation's minerals industry.

The deductibility of percentage depletion has been amply proven to be a sound and effective incentive for minerals exploration and development, and it ought to be maintained. The President's tax proposals emphasize the need to preserve oil incentives which we applaud. The same need is also true for

---

(footnote continued from previous page)

competitiveness, as well as for adjustment to interruptions in supply of critical minerals and materials;

...

8) the importance of materials to national goals requires an organizational means for establishing responsibilities for materials programs and for the coordination, within and at a suitably high level of the Executive Office of the President, with other existing policies within the Federal Government.

[2] See, e.g., Subcommittee of Mines and Mining of the House Committee on Interior and Insular Affairs, 96th Cong., 2d Sess., U.S. Minerals Vulnerability: National Policy Implications (Committee Print No. 9), xii-xiii [hereinafter Committee Report].

hard minerals, especially since governments of other nations, both developing and developed, actively encourage and support mineral development through any number of devices from tax incentives, risk-sharing and guarantees, through flexibility in the application of regulations, to more liberal antitrust policies.[3]

Case for Percentage Depletion

There are two basic reasons why the percentage depletion allowance is a proper element of a fair tax system:

(1) A mineral deposit is a unique wasting asset for which the percentage depletion allowance is necessary in order to provide for cost replacement.

(2) The massive capital requirements, above-average risks and long lead times from exploration to commercial production, which are inherent in the mining industry, require the percentage depletion allowance to provide an incentive that will generate the needed capital for expansion of mineral production.

Cost Replacement

A mineral deposit is a wasting asset that requires investments in exploration, acquisition and development in order to yield a flow of commodities over its productive life. As is true of other assets, the value of a mineral deposit diminishes with its depletion.

In sharp contrast to a manufacturing facility, however, where original cost is a reasonable indicator of replacement cost (inflation effects aside), the original cost of land and mineral deposits is an inadequate measure of the cost required to discover and develop a replacement for exhausted reserves in a new location. Historical evidence clearly proves that exhausted mines are replaced with deposits that are more difficult and expensive to discover and -- because of lower ore grade or greater difficulty to mine and develop, or both -- are much more expensive to operate, even after adjusting original costs for inflation.

---

[3] *Id.* at 73.

The percentage depletion allowance responds to the unique nature of a mineral deposit and provides a realistic and practical method of reflecting the decreasing or wasting value of a mine as it is depleted, and so it encourages the capital investment needed for its replacement.

Capital Needs and Risks

Capital needs for development of new minerals production are enormous. Increasingly, new mine developments are in remote or difficult terrain and usually of lower grade ore bodies so capital and operating costs escalate. Moreover, the lead time required to bring a project into commercial production is extensive, often seven to ten years from the time exploration commences. The staggering costs of environmental, reclamation and safety regulations add to the needed outlays.[4]

In recent years, the U.S. mining industry has had insufficient earnings and cash flow to generate internally the funds needed to meet its capital demands. (In some cases the profitability of certain domestically-produced minerals has been depressed as a result of excessive production by government-controlled overseas operations which trade profitability for employment and foreign exchange. Total production costs of some government-controlled operations are actually higher than those of domestic operations and in times of low prices debt servicing and other indirect costs are allowed to slide.[5]) A review of various mining companies' financial statements filed with the SEC and/or in reports to shareholders reveals substantial losses for mining operations in recent years. As a consequence, the industry's long-term indebtedness has mounted substantially to levels approaching 50 percent of capitalization in a number of cases. If this trend continues, the industry's borrowing power will be exhausted long before its huge capital requirements are satisfied, and the U.S. will become more vulnerably dependent on foreign sources for minerals of strategic importance.

---

[4] Id. at xiii.

It is also a fact that investing in the replacement of mineral deposits involves greater risk than investing in general capital goods, so a premium is necessary to attract the necessary financing. The percentage depletion allowance reduces tax burdens on the mining industry, and the resulting improvement in profitability -- or at least the prospects of it -- helps to attract the interest of investors.

---

[5] Committee Report at 39.

If our national policy is to continue the encouragement of private enterprise to build and enhance America's minerals base, as clearly it should be, continuation of depletion allowance must remain a vital part of such a policy.

Since many minerals are commodities whose prices are set by the world marketplace, an increase in mining costs through repeal or diminution of the percentage depletion allowance could not be passed on in the form of increased selling prices. Accordingly, if Congress were to increase mining costs by repeal or curtailment of the depletion allowance, the results would be to:

(1) Discourage production of domestic basic minerals.

(2) Discourage exploration and development of new domestic resources.

(3) Increase imports of materials of strategic importance from vulnerable foreign sources.

(4) Impair the ability of U.S. mining companies to compete for those needed foreign sources of minerals where adequate reserves do not exist in the United states.

A recent report by the U.S. Bureau of Mines regarding copper is equally applicable to all mineral resources.[6] It states:

> "... given the increase in production costs and the subsequent increase in copper importation that would result from this repeal (of percentage depletion), it is quite clear from a national income point of view the

---

[6] "The Depletion Allowance and Domestic Minerals Availability -- A Case Study in Copper" by Paul R. Thomas, Robert L. Davidoff and Melinda M. Quinn (Information Circular 8874).

> ultimate income transfer would be from domestic copper producers to foreign copper producers. The loss of domestic mining income and employment and the associated loss in domestic tax revenues that this implies, as well as the explicit cost of the additional copper imports for the U.S. balance of payments, would more than offset any gain in corporate income revenues that the Federal Government might obtain from repealing this allowance."

Recommendation 4B.6 of the National Commission on Materials Policy is as valid today as it was when made in June, 1973:

> "We recommend that
>
> 4B.6 ... the Congress continue the percentage depletion provisions of our tax laws as a time-tested major incentive to discovery and development of mineral resources. These provisions should not be further reduced unless and until a better incentive system can be developed."

Exploration and Development Expenses

Nearly all finished goods contain raw materials mined from the earth, but few of their producers need the massive capital investments and long periods of exploration and development that mining requires. Likewise, few industries have as high an investment risk as mining.

Recognizing these fundamental facts, as well as the strategic importance of mining to U.S. national security and economic well-being, Congress has long included in the tax laws provisions that permit a current deduction for mine exploration expenses and mine development expenses.

In recent years, however, these fundamental facts and basic policies have been lost sight of. Mine exploration and development expenses have been labelled "preferences" and the previous tax treatment of allowing current deductions has been curtailed. In addition, the President's tax reform proposal would classify 90 percent of the deductible portion of the exploration and development expenses actually incurred as a "preference item" thus subject to the new alternative minimum tax.

These actions represent a serious threat to the financial well-being of the mining industry in this country. They not only increase the tax burden that the industry must bear, in total frustration of the long-standing policy of providing incentives to encourage the exploration for and development of this country's natural resources. They also negatively impact the mining industry's ability to utilize efficiently the capital investments that the industry must commit if it is to meet the country's demands for basic raw materials. This is especially significant because these are difficult times when uneconomical mines are being closed and new mines must be opened to replace these properties and others that are being depleted. By increasing the industry's tax burden, and delaying the time at which tax benefits can be realized from nonproducing activities at a mine, these actions threaten the industry's ability to accumulate the capital that it requires to develop new properties and, thus, to continue to meet the country's demands for basic raw materials.

Corporate Minimum Taxes

The American Mining Congress is opposed in principle to a minimum tax on corporations, whether an add-on tax such as is contained in present law or an alternative minimum tax such as has been proposed by the President, which is based on the concept that certain deductions, credits, etc. (tax preferences) are to be reduced in value when used by lower income operating corporations when these same deductions, credits, etc. are fully available to high income corporations.

In addition to the objectional aspect that a "preference-based" minimum tax apparently attempts to do indirectly what presumably cannot be legislated directly, its penalties do not fall upon taxpayers in any fair or uniform manner. Whether an add-on or an alternative minimum tax, tax penalties will not come into play unless the ratio of income before preferences to the preferences themselves falls below a certain level. As a result, when preferences are found in a taxable corporation that has large amounts of ordinary income, the corporation obtains full enjoyment of the deductions, etc. When preferences are found in a corporation which has relatively lower operating income (as in the case with many mining and other basic industry companies which are in difficulty with low or no operating income because of adverse international trade and other economic environments), the use of the preferences is penalized. The "preference-based" minimum tax often perversely attacks corporations most severely when they are least able to pay.

The penalty upon these struggling operating corporations is particularly unjustifiable since it often results directly or indirectly from the use of capital formation incentives (percentage depletion, capital gains rates, accelerated depreciation, investment tax credits). These incentives are frequently vital to the necessary modernization efforts of these companies.

If, however, it is believed that public perceptions of fairness require that the tax system include some device such as a corporate minimum tax, an alternative minimum tax of the nature proposed by the President is substantially preferable to the add-on minimum tax of present law. In addition, any corporate minimum tax should provide for full recognition of net operating loss carryovers so there is a meaningful distinction in the application of the tax between those corporations which are suffering economic and operating hard times and those corporations which have simply reduced their income to zero by the use of a multiplicity of tax benefits. Moreover, any minimum tax should provide for full recognition of unused investment tax credit carryovers. The President's minimum tax proposal is deficient in this regard and would result in inequitable treatment of modernizing companies with carryover investment tax credits. Since under the President's proposal investment credits would be available only to offset the regular income taxes, the alternative minimum tax at a 20% rate would effectively repeal those unused credits. Instead, if a corporate minimum tax proposal is included in any tax revision package, credits earned under laws which provided that the credits would be of benefit should not be retroactively denied after the investments that earned the credits have been made.

Coal and Iron Ore Royalties

Since enactment of the Revenue Act of 1951, Congress has acknowledged the importance of encouraging the orderly leasing and production of this Nation's coal reserves by the allowance of capital gains treatment for specified coal royalties under section 631(c). The appropriateness of this treatment for iron ore royalties was recognized in the Revenue Act of 1964, and since that time capital gains treatment also has been provided for iron ore royalties.

The President's tax reform proposals by repealing the presently allowed capital gains treatment under section 631(c) for the specified coal and iron ore royalties would strike a further blow at important segments of our domestic mining industry. This is not a time to take steps that discourage or adversely impact the orderly growth and development of the domestic mining industry. The industry is struggling to compete in a difficult international marketplace characterized by unfair competition subsidized by foreign governments and at the same time struggling to rise out of the depression that has affected it for most of the decade. It is not sound policy to further damage these critical segments of the industry by the enactment of adverse changes in our federal income tax laws.

STATEMENT BY KURT SWENSON, PRESIDENT, NATIONAL BUILDING GRANITE QUARRIES ASSOCIATION, BARRE, VT; ACCOMPANIED BY HON. ROBERT McCLORY, BAKER, AND McKENZIE, WASHINGTON, DC

Mr. SWENSON. Mr. Chairman, members of the committee, my name is Kurt Swenson. I am the president of Rock of Ages Corp. I appear today in my capacity as president of the National Building Granite Quarries Association.

It is pretty easy to know what coal and things like that are. You may wonder, what does the granite industry do, who are they, and where are they? We are the guys who take pieces of granite out of the ground and make it into monuments, building granite, granite curb, and related products. In fact, we were looking yesterday outside this building, and the wall surrounding the flowers out there is granite from our quarries in New England. There is a lot of granite used in Washington.

All of our companies are small—very small companies. None of our companies are publicly held. The average sales level of our companies is probably $5 million.

The President's tax bill has this effect on our little industry: Compared to a 50-percent tax increase from the other members of the panel, our survey shows that it will be 125 percent for our industry. The total revenue increase that the Government gets as a result of this is $4 million. Four million dollars, by our survey, is what the Government will get if this happens, and that is $4 million assuming no jobs lost.

I would like to ask, Mr. Chairman, that you hold the record open so that we may submit that survey when it is final.

The CHAIRMAN. I would be happy to.

[The survey follows:]

IMPACT OF THE PRESIDENT'S TAX PROPOSALS ON THE UNITED STATES DIMENSION GRANITE INDUSTRY:

FINAL SURVEY REPORT

Prepared for Submission to
The Committee on Finance
United States Senate

National Building Granite
Quarries Association
Post Office Box 482
Barre, Vermont

November 1, 1985

SURVEY HIGHLIGHTS

Repeal of percentage depletion for dimension granite will raise no more than $4.4 million a year.

Three estimates:

$2.1 million per year;

$4.4 million per year;

$2.3 million per year.

The lower estimates appear to be more accurate.

The tax burden of dimension granite companies will increase dramatically under the Administration's proposals.

Profitable companies will experience an increase of 125 percent.

Even if percentage depletion is retained, these companies will experience 75 percent tax increases.

A loss of as few as 10 percent of current jobs in the dimension granite industry would wipe out direct revenue pickup from repeal of percentage depletion.

TABLE OF CONTENTS

Page

I. Introduction.................................. 1

II. Scope of the Survey......................... 2

III. Revenue Pickup From Repeal of Percentage Depletion for Dimension Granite............. 5

A. Method 1 -- $2.1 Million................ 5

B. Method 2 -- $4.4 Million................ 8

C. Method 3 -- $2.3 Million................ 10

IV. Increased Per Company Tax Burden............ 14

V. Revenue Effects of Employment Losses........ 16

VI. Conclusion.................................. 19

I. INTRODUCTION.

On September 26, 1985, Mr. Kurt Swenson, President of the National Building Granite Quarries Association, appeared before the Committee on Finance of the Senate to testify in opposition to the proposed repeal of percentage depletion for dimension granite producers. Mr. Swenson testified that the National Building Granite Quarries Association was in the process of conducting a survey of the dimension granite industry to ascertain the impact of the Administration's tax proposals, particularly the repeal of percentage depletion, on that industry. He further testified that preliminary results from the survey, which had not then been completed, indicated that no more than $4 million would be raised annually from the repeal of percentage depletion for the dimension granite industry. In addition, preliminary results of the survey indicated that the typical dimension granite company would experience an increased tax burden of approximately 125 percent under the Administration's tax proposals.

At the time of his testimony, Mr. Swenson asked that the record of the hearing be held open so that the final results of the survey could be included when the survey was completed. This report contains the final results of that survey.

II. SCOPE OF THE SURVEY.

The dimension granite industry consists of approximately 200 companies employing 9,600 people. 1/ As many of these companies as could be identified were asked to respond to a survey designed to elucidate information necessary to determine (a) the total potential revenue pickup within the dimension granite industry from repeal of percentage depletion for granite; and (b) the overall effect of the major elements of the Administration's tax reform proposals on the tax liability of companies in the dimension granite industry. 2/ The companies responding were assured confidentiality; accordingly, no company-by-company figures are set forth in this report.

Responses were received from companies employing 29.9 percent of those employed in the dimension granite industry. 3/ The typical company responding to the survey had 40 employees, 4/ although the smallest employed only 10

1/ Bureau of Mines, United States Department of Interior, Dimension Stone at 6, preprint from MINERAL FACTS AND PROBLEMS (Bulletin 675) (1985) (hereinafter cited as Dimension Stone). This figure is as of 1983, the last year for which data are available.

2/ A copy of the survey questionnaire is appended.

3/ I.e., 2,868 employees out of 9,600.

4/ Median value used.

people. Seven companies employing more than 100 workers responded. The foregoing indicates that although the survey covers the entire range of companies in the dimension granite business, from those with the fewest employees to those with the most, large companies were more likely to respond to the survey. Consequently, the larger dimension granite companies are somewhat overrepresented in the survey results. This is not unexpected, because larger companies are more likely to have trained staff with the time to respond to the survey within the short period required by the exigencies of the legislative process.

The survey information is drawn from the most recent tax return for the company. In almost all cases, that year was the 1984 calendar year. Another approach would have been to ask for information for each of the taxable years in a "base period" of three or more taxable years. Such approach would have minimized the chance that the survey results from a particular company would represent an atypical year. However, given the economic recession that hit all domestic industries in the 1981-83 period, such a "base period" would tend to understate substantially the current profitability of the dimension granite industry, and, accordingly, understate the revenue impact of repeal of percentage depletion.

On the basis of the large proportion of the dimension granite industry covered and the range in size of the companies responding, we are confident that the survey results are a reliable indication of conditions in the dimension granite industry generally.

III. REVENUE PICKUP FROM REPEAL OF PERCENTAGE DEPLETION FOR DIMENSION GRANITE.

Three different methods were used to determine the potential revenue increase from repeal of percentage depletion for granite. Based on these methods, repeal would raise somewhere between \$2.1 million and \$4.4 million annually from companies in the dimension granite industry. In each case, as appropriate, the effects of the Administration's tax reform proposals with respect to corporate rates, investment tax credit, and cost recovery were taken into account. Transition rules were ignored and the Administration's proposals were treated as fully implemented in order to give an accurate picture of the full impact of those proposals on the dimension granite industry.

A. Method 1 -- \$2.1 Million.

The first method used to estimate revenue pickup is based on comparing tax liability under the Administration's proposals with current tax liability. This yields the increase in tax liability as a result of all proposed changes in the Administration's tax package. This increase is then adjusted to remove the increase in tax liability that results from changes other than repeal of percentage depletion. The result is that amount of increased tax liability that flows solely from repeal of percentage depletion.

The first step in this method is to determine the tax liability of each company responding to the survey under the rules set forth in the Administration's tax proposals. Accordingly, for each company the "taxable income" figure reported in the survey was adjusted as follows: First, taxable income was increased by the amount of percentage depletion claimed, and decreased by the amount of cost depletion that would be allowable. This adjustment reflects the repeal of percentage depletion; companies would still be allowed to deduct cost depletion under the Administration's proposals.

Second, the tax liability of each company was determined by applying the appropriate corporate tax rate under the Administration's proposals to the taxable income as adjusted above. In many cases, companies responding to the survey were small, and the graduated tax rates set forth in the Administration's proposals were the relevant tax rates rather than the 33 percent rate that would be applied generally.

Third, from this tax liability we subtracted the company's tax liability under present law. Because such present-law liability reflects use of the investment tax credit, which would not be available under the Administration's proposals, such liability was increased by the investment tax credit claimed by the company as indicated in the survey response.

The result of this process is the difference between a company's tax liability under present law and its liability under the Administration's proposals that is due solely to the repeal of percentage depletion. The difference for each company responding to the survey was determined in this manner, and the differences added up, to obtain the total increase in tax liability among the companies surveyed that results solely from the repeal of percentage depletion.

To extrapolate this figure from just those companies which responded to the survey to the dimension granite industry as a whole we used the employment figures. Because 29.9 percent of the employees in the dimension granite industry were covered in the survey, it was assumed that the total tax increase among the companies responding to the survey would be equal to 29.9 percent of the tax increase of the whole dimension granite industry.

This method for estimating the revenue pickup from repeal of percentage depletion for the dimension granite industry yielded a figure of $2,063,810, or approximately $2.1 million. Accordingly, it appears that Federal tax revenues would increase by only $2.1 million each year as a result of repeal. Because the effect of minimum tax on current tax liability was not taken into account, this figure probably overestimates the amount of new revenue that would be generated. In addition, the probability that companies will fail under the higher tax burden imposed by the Administration's tax proposals has not been factored in. To the extent present companies should go out of business, the revenue pickup will be less than estimated above. 5/

B. Method 2 -- $4.4 million.

The first method, described above, is conceptually the best because it takes into account all the changes proposed in the Administration's tax reform proposals. The second method, by contrast, looks just to the amount of percentage depletion as claimed by the companies responding to the survey to determine the revenue pickup from repeal of percentage depletion.

Under the second method, the amount of percentage depletion claimed by the companies responding to the survey

---

5/ Section V of this report, below, does estimate how few jobs need be lost for this potential revenue pickup to be wiped out.

was totaled. As in the Method 1, this amount was extrapolated to the dimension granite industry as a whole by assuming that the amount of percentage depletion claimed by companies responding to the survey represented 29.9 percent (based on employment figures) of the amount of percentage depletion claimed by the whole industry.

This figure was then multiplied by 33 percent, the highest corporate rate set forth in the Administration's tax proposals. In other words, the maximum tax rate was applied to the amount of the deduction for percentage depletion our survey indicated was currently claimed by the dimension granite industry. The result is a figure of $4,374,827--or $4.4 million, rounded--for the annual revenue pickup from repeal of percentage depletion for the dimension granite industry.

The estimate arrived at under this method is more than double that determined under the first method. The major reason for this difference is the different tax rates imposed on the amount of percentage depletion under the two methods. Under the first method, the amount of percentage depletion is taxed at the graduated rates that apply under the Administration's proposals to small corporations, i.e., 15 percent on the first $25,000 of taxable income, 18 percent on the second $25,000 of taxable income, and 25 percent on the third $25,000, with the flat 33 percent rate not applying until total taxable income was higher than $360,000. Very few of the companies surveyed had taxable incomes under the Administration's proposals as high as $360,000, and over half had taxable incomes of less than $100,000. Under the second method, the amount of percentage depletion is taxed at the flat 33 percent rate.

Because of the second method's approach, it overestimates the revenue pickup from the dimension granite industry by ignoring the fact that the industry is composed primarily of small businesses. However, it does indicate the highest potential revenue pickup from repeal of percentage depletion for the dimension granite industry.

C. **Method 3 -- $2.3 Million.**

In contrast to the first two methods, this method does not make use of data from the survey. Rather, this method estimates the total revenue pickup from repeal of percentage depletion by looking at total United States dimension granite production as established by United States government sources.

The amount of percentage depletion that a company can claim is based on its gross income from mining the mineral multiplied by a statutorily specified percentage. In the case of the dimension granite industry, 14 percent is the prescribed figure. Accordingly, if the total income from mining dimension granite in the United States can be determined, the total amount of percentage depletion that could be claimed can be determined. The total potential revenue pickup can then be computed using the appropriate tax rate.

The average annual production of dimension granite in the United States for the period from 1973 through 1983 was 499,272 tons of dressed stone equivalent. 6/ Tax regulations make clear that percentage depletion for dimension stone is based on production of undressed, rather than dressed, stone. 7/ The above figure must be adjusted so as to represent undressed stone. The Bureau of Mines has determined that one ton of undressed stone is equivalent to .7 ton of dressed stone. 8/ Applying this, United States domestic production of rough (undressed) dimension granite averages about 713,246 tons annually.

Direct contact with members of the dimension granite industry indicates their cost per ton of undressed granite

---

6/ Dimension Stone, p. 4.

7/ Treasury Regulations section 1.613-4(g)(6)(iv).

8/ Dimension Stone, p. 4.

is approximately \$57.00.[9] This figure must be increased by the typical profit per ton to reach the income figure required for determining percentage depletion. Profitability in the industry is apparently low. However, to be conservative a profit margin of 20 percent was assumed. This yields a per ton profit of \$11.40. Combined with the \$57 cost per ton, we arrived at a figure of \$68.40 per ton of undressed dimension granite as an appropriate figure to use to determine the gross income from mining.

Using these figures, the maximum annual gross income from mining dimension granite would be \$48,786,026. This figure represents the maximum amount of income with respect to which percentage depletion can be claimed by dimension granite producers. Multiplying this figure by 14 percent, the allowable percentage depletion under the statute, yields a figure of \$6,830,044 as the amount of percentage depletion that is potentially claimable by United States dimension granite producers in a typical year.

Under the highest marginal rate proposed by the Administration for corporations, 33 percent, the maximum tax benefit that a deduction of \$6,830,044 for percentage

---

9/ Average cost appears to be \$5 per cubic foot, and there are 11.428 cubic feet per ton of granite. Dimension Stone, p. 4.

depletion can yield is $2,253,914. Accordingly, the potential revenue pickup estimated under this method is approximately $2.3 million annually. This result is close to the result yielded by the first method, and, because it is based on non-survey data sources, gives confidence that the result produced by the first method is not only accurate but more likely to be accurate than the second method.

IV. INCREASED PER COMPANY TAX BURDEN.

Besides determining the overall revenue pickup from repeal of percentage depletion, the survey also looked at how the tax burden on a typical company in the dimension granite industry would be increased by the Administration's tax proposals. In particular, we were able to determine that the typical profitable dimension granite company would see its taxes increased by 125 percent as a result of the Administration's tax proposals being fully implemented. Even if percentage depletion for granite were not repealed, other changes in the Administration's proposals would result in average tax increases of 75 percent.

To arrive at these figures, each company responding to the survey that showed a profit for tax purposes had its tax liability calculated in three ways -- first, under present tax law; second, under the law as modified by the Administration's tax proposals; and, finally, under the law as modified by the Administration's tax proposals, except that percentage depletion for granite was treated as retained. Only profitable companies were used, since percentage increases cannot be calculated in cases where the base for the increase, i.e., current profit, is zero or negative. 10/

The results of our survey in this regard are in line with results that were found in a survey of the entire mining industry conducted by the American Mining Congress. 11/ In that survey, the typical profitable mining company would see its taxes increase by approximately 50 percent. Our survey arrives at a higher increase. This difference is accounted for largely by the small size of companies in the dimension granite industry as compared to the typical mining company. The proposed rate reductions benefit larger companies far more than small businesses, because, in fact, there is no rate reduction in the Administration's proposals for companies with taxable incomes of less than $50,000 a year, and only small rate reductions for the next $50,000 of income. 12/

10/ A significant proportion of those companies responding to our survey did not show a profit from operations. Accordingly, we are less confident of these results of our survey than of our estimates of revenue pickup.

11/ American Mining Congress, Impact of the President's Tax Reform Proposals on the United States Mining Industry (September 1985) (submitted to the Senate Finance Committee in connection with testimony by the American Mining Congress on September 26, 1985).

12/ I.e., a 5 percentage point drop for taxable income in the 50,000 to 75,000 range, from 30 percent to 25 percent, and a 7 percentage point drop for taxable income from $75,000 to $100,000, from 40 percent to 33 percent.

V. REVENUE EFFECTS OF EMPLOYMENT LOSSES.

The foregoing has assumed that all dimension granite companies would stay in business and that current employment would remain the same after the full implementation of the Administration's tax proposals. Manifestly, this will not be the case; some companies will go out of business as a result of the huge tax increases in store for the dimension granite industry under the Administration's proposals. The purpose of this section of the report is to estimate the effect of losses in employment in the dimension granite industry on the revenue pickup estimates set forth in Section III. of this report.

To that end, each of the companies responding to the survey was asked to report the total Federal income tax withheld on behalf of their employees. The companies in the survey withheld an average of $2,539 per employee. It was assumed that the amount withheld was exactly equal to the employee's tax liability. Multiplying this amount by the 9600 employees in the dimension granite industry shows that the total Federal revenue derived from income taxes paid by those employees is approximately $24,374,400.

According to the Administration's tax proposal, total taxes paid by individuals would decline by 7 percent. [13] A decline of 7 percent results in total taxes of $22,668,000 from employees in the dimension granite industry under the Administration's proposals.

Three estimates of the potential revenue pickup from repeal of percentage depletion for the dimension granite industry were set forth above. The first estimate, $2.1 million, is only 9.2 percent of the total income tax revenue from dimension granite industry employees. Accordingly, if only 9.2 percent of the current jobs in the dimension granite industry were lost, no net revenue gain would result. Stated differently, a loss of only 890 jobs would wipe out the revenue pickup from repeal of percentage depletion.

The pickup of $4.4 million estimated under the second method would be wiped out by a loss of 19.4 percent of the industry's jobs, or 1,863 jobs. The $2.3 million revenue pickup estimated under the third method would be negated by a loss of only 10.1 percent of current employment, a loss of only 974 jobs.

---

[13] The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity: Summary 3 (May 1985).

Not considered, of course, are the indirect revenue losses that result from lowered purchases by the unemployed and increased use of governmental assistance by them. Although these losses have not been estimated in this report, it is reasonable to concluded that employment losses in the dimension granite industry would need to be even less than indicated above to completely negate any potential revenue pickup from repeal of percentage depletion for the dimension granite industry.

VI. CONCLUSION.

The survey conducted by the National Building Granite Quarries Association leads to the following conclusions concerning the impact of the Administration's tax proposals on the dimension granite industry:

1. Revenue pickup from repeal of percentage depletion will be minimal at best, totaling somewhere between $2.1 million and $4.4 million annually.
2. Dimension granite companies will experience dramatically increased tax burdens, in the range of 125 percent.
3. Even if percentage depletion is not repealed, other proposed changes will lead to an increase of 75 percent for the typical dimension granite company.
4. Any direct revenue pickup from repeal of percentage depletion would be wiped out by employment losses of no more than 19 percent, and perhaps as little as 10 percent.

Appendix

GRANITE INDUSTRY TAX SURVEY

Using your company's most recent tax return, please provide the following information. The form and line numbers for the 1984 Form 1120 have been indicated to assist you. Your responses will be kept confidential and used only to determine overall effects of the Administration's tax proposals on the dimension granite industry.

1. Gross Income
   (Form 1120, Line 11).............................. ________
2. Depreciation
   (Form 1120, Line 20).............................. ________
3. Percentage Depletion
   (Form 1120, Line 22).............................. ________
4. Taxable Income Before NOL Deduction
   (Form 1120, Line 28).............................. ________
5. Investment Tax Credit
   (Form 3468, Line 14).............................. ________
6. Cost Depletion (estimate)
   Estimate this amount by multiplying the basis of the granite-producing property by a fraction. The fraction consists of the amount of granite actually produced during the year divided by the total amount of recoverable granite in the property as of the beginning of the year.............................. ________
7. Total number of employees........................ ________
8. Total Federal income tax withheld on
   behalf of employees.............................. ________

Mr. SWENSON. I think I can guarantee you, if this President's bill passes, there won't be any revenue pickup of the $4 million that is involved. The reason is that the employment loss in our industry would completely wipe out any revenue gain. We estimate that that would be a 17-percent reduction in employment. Let me explain to you why there would be jobs lost.

In the last 7 years, imports in granite have gone up 1,400 percent; the highest increase on record was the last reported year between 1983 and 1984 when they went up 84 percent. Imports now control 30 percent of the market for granite.

What that means is, we can't raise prices. We don't have quotas or anything to protect us; we are just a small little stone industry. Nobody hears about us. So, we don't have those kinds of things to help us.

The administration itself noted in its presentation that, given the decline in mineral prices, immediate termination of the depletion allowance would cause sufficient job dislocation. I don't care whether you phase it in or not, that job dislocation will occur in the granite industry.

I think everybody has to keep in mind that tax reduction doesn't help anybody who loses their job.

What are the other countries doing? Our situation is that these governments provide outright 50-percent grants for the costs of equipment; they pay the labor force for a year. Their job, as they see it, is to put people to work and take them off the public welfare rolls.

The depletion allowance that is proposed to be repealed involves a non-renewable resource. Quarries make big holes in the ground. They are very difficult to replace. Not only that, there is a minimum tax on depletion, and it is dependent on profits. You don't get the benefit of depletion unless you pay tax.

We are not tax shelters; ask yourself if you have ever heard of a granite tax shelter. They don't exist.

The investment tax credit also hits us. That is simply a matter of accelerating cost recovery; that's all that it does. We get 10 percent. That is in the face of governments who give outright grants of 50 percent to our competitors.

I testified here in I think it was 1975 on trade adjustment assistance. Our company received a loan from trade adjustment assistance, which I am happy to report we paid back in full. But trade adjustment assistance comes too late. By then the damage is done. My opinion is that this tax bill will on all heavy smokestack industries, and in particular on the granite business, cause severe problems that simply are not something that the country needs at this time.

Thank you.

The CHAIRMAN. Thank you, Mr. Swenson.

(Mr. Swenson's written testimony follows:]

STATEMENT OF KURT M. SWENSON,
PRESIDENT, NATIONAL BUILDING GRANITE QUARRIES ASSOCIATION
TRUSTEE, BARRE GRANITE ASSOCIATION

Introduction.

My name is Kurt M. Swenson and I live in Hopkinton, New Hampshire. I am the President of the John Swenson Granite Co., Inc., of Concord, New Hampshire, and Rock of Ages Corporation of Barre, Vermont. Both of these companies are engaged in the dimension granite business. As the President of the National Building Granite Quarries Association, and as a Trustee of the Barre Granite Association, I represent today about 40 companies in the dimension granite business.

The testimony of the other witnesses on today's panel has given you the "big picture" of the effects of the Administration's tax reform proposals on the mining industry, with particular attention to the giants of the hard minerals industry--iron ore and coal. By contrast, I am here to inform you of the effects of the Administration's proposals on one small industry--the dimension granite business. Our industry manufactures granite for building and construction, monuments, and curbing. Many of the buildings here in Washington are faced with our granite.

Nationwide, our industry employs only 9,600 people, [1] our businesses are all small family owned companies, and, consequently, our industry's contribution to the gross national product is negligible. But repeal of percentage depletion for granite, as proposed by the Administration, will nevertheless be catastrophic for our industry and the small communities that depend on it. In the rural areas of Vermont, Minnesota, Georgia, Texas, North Carolina and elsewhere where the dimension granite industry is concentrated, what is "negligible" on the national level looms as a disaster on the order of magnitude of the Great Depression.

Imports Have Devastated the United States Dimension Granite Industry.

A tidal wave of foreign imports has engulfed the United States dimension granite industry. As the table below indicates, imports of dimension granite stone have increased dramatically in the period from 1977 through 1984. Each year, on average, imports increased 50 percent over the preceding year. This results in a phenomenal increase of 1,432 percent over the seven-year period--a factor of over

---

[1] Bureau of Mines, United States Department of Commerce, MINERAL FACTS AND PROBLEMS 6 (preprint 1985) (Bulletin 675) (hereinafter cited as "Bureau of Mines Report").

14. This increase has come almost entirely at the expense of the domestic dimension granite industry.

Imports of Dressed Dimension Granite by Volume
1977-1984

Year	Volume */	% Increase in Value Over Prior Year
1977	231	----
1978	256	10.8
1979	396	54.7
1980	456	15.2
1981	691	51.5
1982	1,228	77.7
1983	1,923	56.6
1984	3,539	84.0

---

*/ Volume in 1,000's of cubic feet.

Source: 1977-1983: Imports IM 146, TSUS item 513.74 (microfiche), Bureau of Census, U.S. Department of Commerce.
1984: United States General Imports and Imports for Consumption: Schedule A, Commodity by Country, p. 2-109, Bureau of Census, U.S. Department of Commerce (1985).

United States demand for dimension granite has remained stable over the same seven-year period, but imports have risen from a little over 10 percent of domestic consumption eleven years ago to at least one-third, if not more, as of

1984. [2] As a result, over the last twenty years, over twenty thousand jobs have been lost.

This rising tide of imports is not a result of a lack of efficiency or competitiveness of the United States dimension granite industry. Rather, it has largely been a result of the policies of the United States government, which have encouraged a strong dollar and thus promoted imports at the expense of domestic producers. [3] Further, countries such as Italy, Brazil, and Spain, which together account for approximately 85 percent of the dimension granite imported into the United States, provide substantial direct and indirect tax and other subsidies to their granite industries. [4] The dimension granite producers of this country are not competing in a free market, but rather have been placed in a situation where foreign competitors have been the beneficiaries of not only their own governments' unfair subsidies but also of the United States government's strong dollar policy.

---

[2] These figures are based on data supplied in the Bureau of Mines Report, p.4. In 1973, imports accounted for 11.4% of United States consumption by weight, while in 1983, they accounted for 28.2% by weight. Given the 84% increase in imports for 1984, we estimate that imports must now account for approximately one-third to forty percent of current domestic consumption.

[3] Bureau of Mines Report, p. 6.

[4] United States General Imports and Imports for Consumption: Schedule A, Commodity by Country, p. 2-109, Bureau of Census, U.S. Department of Commerce (1985).

Nevertheless, the granite producers of the United States have not meekly submitted to this foreign competition. Nor have they turned to Congress for assistance. Instead, over the last several years, the members of the dimension granite industry have invested millions and millions of dollars in new technology in an effort to preserve and protect the United States industry and its employees. To our complete dismay, at this most critical time in our beleaguered history, Congress is being asked by the Administration, in a tax reform proposal heralded as promoting simplicity and fairness, to put the final nail in the coffin of the domestic dimension granite industry. 5/

Repeal of Percentage Depletion Will Raise No More Than $4 Million in New Revenues, and Probably Less.

Repeal of percentage depletion for granite will generate only minimal additional tax revenue from the dimension granite industry at best, and, given the damage

---

5/ Our industry's program to modernize so as to compete effectively with foreign competition will also be severely undercut by the Administration's proposal to end the investment tax credit.

that will surely result in the form of businesses failing and job losses, it is probable that repeal will actually result in a net decrease in tax revenues. The National Building Granite Quarries Association is in the process of conducting a study of the impact of the repeal of percentage depletion for granite on the domestic dimension granite industry. Although the survey is as yet incomplete, we have enough information now to draw some conclusions. We will make the final results of our survey available to you as soon as it is complete; however, it is unlikely that the final results will differ greatly from those described below.

The most dramatic result of our survey is that repeal of percentage depletion for granite will raise less than $4 million annually in tax revenues over present law, based on 1984 operating results. In arriving at this figure, we assumed that all the Administration's proposals became law and ignored any transitional rules. This estimate is probably high, in that we assumed that all present dimension granite companies would remain in business and that all would be profitable. Clearly, a number of these companies will go out of business, and a number of them are not currently profitable. Accordingly, to the extent that imports make further inroads into the dimension granite market and domestic production falls, the actual revenue pickup may be considerably less than $4 million per year.

Dimension Granite Producers Will Experience Tax Increases Averaging 125 Percent.

Although the tax increase, in absolute terms, is negligible, it is ruinous to the small businesses of our industry. Our survey indicates that the average dimension granite company will have an increase in its federal taxes of approximately 125 percent by reason of the Administration's tax proposals. Strikingly, even if percentage depletion for granite were not repealed, other changes in the Administration's tax proposals, such as repeal of the investment tax credit, would result in taxes increasing an average of over 50 percent per company in the dimension granite industry.

Part of the reason the tax burden of companies in our business will increase so dramatically under the Administration's tax proposals is that most of our companies are small businesses which do not benefit much, if at all, from the proposed reduction in corporate tax rates. As this Committee is aware, taxable corporate income of less than $50,000 is taxed at exactly the same rates under both the current Internal Revenue Code and the Administration's proposals. A large number of the granite producers in this country have taxable incomes in this low range. Accordingly, including additional revenue by reason of loss of the percentage depletion deduction will be a pure tax increase for these producers, totally unmitigated by the proposed rate reductions.

Tax Losses Resulting From Lost Employment May Totally Negate Any Direct Increase in Tax Revenue from Repeal of Percentage Depletion for Granite.

Tax increases of this magnitude will make it difficult, if not impossible, for many dimension granite producers to remain in business. At very least, we would expect a substantial decline in employment as a result of some companies going out of business and others paring down their workforces. This will have the effect of wiping out much, if not all, of the revenue gained by repealing percentage depletion. Our survey indicates that a drop in employment of only 16.8 percent in the dimension granite industry will result in a loss of federal income taxes paid by those individuals equal to the revenue pickup from repeal of percentage depletion. I can guarantee you that this employment loss will occur if the Administration's proposals are enacted.

The Economic Impact of Repeal of Percentage Depletion for Granite Will be Severe in Affected Communities.

The economic impact of even marginal losses in business and employment on the communities in which dimension granite is produced would be severe, because these communities depend heavily on the dimension granite industry for employment. For instance, in Elberton, Georgia, sixty percent of the non-farm workers are employed by companies in the dimension granite business. Cold Spring, Minnesota, Barre, Vermont, and Marble Falls, Texas are towns similarly dependent on a healthy United States dimension granite industry. But these areas have been hard hit already by the tremendous increase in imported dimension granite. A further blow in the name of some philosophic ideal of "reform" will create and perpetuate poverty among those communities least able to survive such blows.

It is not unfair to say that the Administration's tax proposals, and particularly the repeal of percentage depletion for granite, will most probably destroy the domestic dimension granite industry. A few of the larger companies may survive, but most of the companies are small and do not have the financial resources to weather yet another storm. These catastrophic effects are a high price to pay for increasing the revenue of the United States government by less than $4 million each year. The actual result will be a net loss to the Treasury in the form of lost individual tax revenues and unemployment compensation offsetting any revenue gain.

The Administration's Tax Proposals are not Fair to the Dimension Granite Industry.

The key issue that has emerged in the ongoing debate over tax reform has been that of fairness. With respect to the dimension granite industry, the Administration's tax reform proposals are not only manifestly unfair, they make no real sense at all. Thousands of jobs and a whole industry, and the areas that depend on it, are threatened by a reform that will raise only a negligible amount of revenue, if any at all.

The ramifications from the Administration's proposals are immense and all of them must be analyzed before a step is taken in the name of simplification which will have the result of destroying an industry. As a capital-intensive "smokestack" industry, the granite industry would be among those most severely affected by other portions of the Administration's proposal. Abolishing the investment tax credit and changing depreciation schedules would hit our industry and other heavy industries very hard. The service and financial industries, in contrast, would achieve significant tax savings from the Administration's proposal. If the granite depletion allowance is repealed, the members of our industry simply want Congress to know that such action will put an entire segment of the small business community on the brink of collapse.

We know that both Congress and the President want to enact a fair and equitable tax system. But fairness and equity are not achieved by driving small businesses into bankruptcy and devastating the economies of whole areas. Individuals are not benefitted by measures that alleviate their income tax burden by relieving them of jobs.

Conclusion.

In summary, we strongly urge that percentage depletion with respect to granite be retained. The dimension granite industry is only barely surviving under the onslaught of imports, and loss of percentage depletion would ring its death knell. In return for a possible increase in the Treasury's coffers of no more than $4 million a year, an old and respected American industry, which has contributed so much to the beauty and durability of our cities, would be destroyed.

Kurt M. Swenson
President
National Building Granite
Quarries Association
Box 482
Barre, Vermont 05641

(802) 476-3115

Appearing on behalf of:
- National Building Granite Quarries Association
- The Barre Granite Association
- The John Swenson Company, Inc.
- Rock of Ages Corporation
- Other interested granite companies

The CHAIRMAN. What do the countries give—a 50 percent what?

Mr. SWENSON. Outright grants.

The CHAIRMAN. What do you mean outright grants?

Mr. SWENSON. Well, I can tell you one story. We had a proposal from a country, Ireland as a matter of fact, where, if we were to erect a plant over there, and we used a price of $7 million, they would give us--give us—$5 million.

The CHAIRMAN. OK, I see what you mean, grants just to locate your plant there.

Mr. SWENSON. That's right.

The CHAIRMAN. OK. And they will also pay all of your workers' wages for a year?

Mr. SWENSON. Approximately a year, because they feel that that is a job-training period.

Senator BAUCUS. Where? In Ireland?

Mr. SWENSON. This particular example was Ireland.

The CHAIRMAN. Mr. Leisenring, let me ask you a question. I was intrigued with the exported coal figures and the balance of payments. We export 81 million tons of coal?

Mr. LEISENRING. That is correct, sir.

The CHAIRMAN. Last year, I mean.

Mr. LEISENRING. Yes.

The CHAIRMAN. And we have a $4 billion net balance of payments on it?

Mr. LEISENRING. That is correct.

The CHAIRMAN. How much do we import?

Mr. LEISENRING. There is very little coal being imported into this country now, Senator Packwood; but I did mention in my testimony that the Republic of Colombia has developed a very, very large coal operation jointly between the Republic of Colombia and Exxon Corp., which is going up to 25 million tons a year, and then I think in steps higher to 35 million tons or higher. You can imagine what the labor rates are down in Colombia. Also, half of the venture owned by the Republic of Colombia was financed by the World Bank, IMF, at rates which are not available to Americans.

The CHAIRMAN. Let me interrupt you; I want to ask you a specific question: How much coal do we import now? We export 81 million tons. Carl, do you know?

Mr. BAGGE. About a million tons.

The CHAIRMAN. At the moment?

Mr. BAGGE. Last year.

The CHAIRMAN. So, at the moment we have a sensational export balance, not just in money but about 80 to 1 in terms of coal going out and coal coming in, and no one can really compete with this, short of extraordinary foreign subsidies of some kind.

Mr. LEISENRING. That is correct.

The CHAIRMAN. OK.

Senator Long.

Senator LONG. No questions, Mr. Chairman.

The CHAIRMAN. Senator Baucus.

Senator BAUCUS. Generally, what is your best argument that the Tax Code should be used to counteract unfair foreign competition? Mr. Swenson, you mentioned the Ireland grant as a kind of unfair foreign competition. When Secretary Baker appeared before us, I and others asked him how the United States should counteract other countries' unfair subsidies or grants et cetera. His response was, "Well, do that some way other than through the Tax Code"—use more direct actions like changes in trade laws, or outright expenditures, or grants, but don't use the Tax Code.

What is your response to the Secretary's view? Any of you.

Mr. SWENSON. Well, my response is, first of all we are not here asking for some special change in the tax law; all we are here to do is to ask you to keep it the same. So, that may be a simple answer, but what is the country going to do about the question of imports? What is the country going to do about the issues of job creation? We have had a trade adjustment assistance program in place for a long time; we have had countervailing duty laws in place for a long time. I have been personally exposed to those.

The Government doesn't want to stop imports, and there are probably legitimate reasons for that—better prices, perhaps, and so forth. Trade adjustment assistance? You make loans under the Trade Adjustment Assistance Program, and many of those loans are never repaid. The employees are still lost, because by the time the assistance is granted the company is already dead, and there is nothing it can do to regain its market share.

I don't know that that answers your question, but I view the Tax Code as something that has developed over the years to accommodate industry and jobs and so forth, and all of a sudden to change the rules in the middle of the game is a very, very serious step.

Senator BAUCUS. What you are saying, basically is, don't change the code to delete certain provisions if their deletion would hurt industries which are suffering from increased international competition.

Mr. SWENSON. I think that that is my view. I think I would focus on the issue of job creation and employment. That, to me, is critical.

Senator BAUCUS. Does anyone else have a view on using the Tax Code?

Mr. BEDELL. Well, Senator Baucus, I would certainly second that remark. Don't make the situation worse by increasing the tax burden that presently exists. To go beyond and use the Tax Code to significantly affect the international situation may involve consideration of substantially different alternatives like value-added taxes that have a far more significant effect.

Senator BAUCUS. What if the code is changed, along the lines proposed by the administration? What alternative public policy vehicles are available to assist your industries to counteract unfair foreign competition? Are there any?

Mr. BEDELL. Well, I think we all suffer somewhat from having primarily a tax orientation. But certainly, in the general area of the trade laws, even enforcing the present trade laws with regard to the dumping of foreign commodities in this country, would I believe be a major step in the right direction.

Senator BAUCUS. Thank you.

The CHAIRMAN. Senator Symms.

Senator SYMMS. Thank you, Mr. Chairman.

One thing that I think also should be mentioned, and I make this in the form of a statement to Senator Baucus's questions about where we are in the industry both in coal and metals, is that one thing that the Congress would have to think about if they invoke this—now, I personally believe that we will leave this tax law alone; at least it will be my effort to see that we do, or if we don't, we probably will be talking about this bill for several years--but one thing we will have to have is a bigger Navy, wouldn't you all agree with that? There is no way out of it, as I see it, as the Soviets expand their fleet all over the world. If we are going to put our mining industry out of business, we simply have to face that question here in the Congress; so we have to have a bigger Navy, we would have to have a picket line of destroyers all the way from Africa to the mouth of the Mississippi so we could run the barges to bring both coal and metals. So, I think that is really important.

But, Mr. Bedell, you made a point that is really dramatic, and I want to just quote it back to you and ask you some numbers on it: "The U.S. metals mining segment is presently only two-thirds of its 1980 size, and employment has been cut in half." How many jobs are you talking about?

Mr. **Bedell**. I don't have the gross number of jobs right at my fingertips; I could certainly supply that for you, Senator.

[The information follows:]"

Senator **Symms**. Furthermore, I made the statement yesterday at a press conference that, if this proposal were passed, we would lose 400,000 more jobs in the metals industry alone. Would you concur with that?

Mr. **Bedell**. Yes, I think so, Senator.

Senator **Symms**. How about in the coal industry? How many jobs would we lose in the coal industry?

Mr. **Leisenring**. We don't have any figures on that; but we do know that the growth of the industry in capital expenditures would be completely dried up, and a great many of the marginal producers, and there are a large amount of marginal producers in the coal industry, would go out of business.

Senator **Symms**. Do any of you have any figures on how much money this proposition will cost the Treasury by having that many more miners, which are generally higher paid jobs, dislocated, and going through the unemployment misery? What the actual loss in dollars in tax revenues to the Treasury as well as outflow in unemployment compensation, readjustment, trade adjustment, and so forth would there be?

Mr. **Leisenring**. For the coal industry we do not have those figures, but I would be happy to see that Price Waterhouse in their study might expand that and make that information available to you and to this committee as soon as possible.

[The information follows:]

NATIONAL
COAL
ASSOCIATION

ROBERT F. STAUFFER
Vice President & General Counsel
(202) 463-2643

October 9, 1985

Mr. Edgar R. Danielson
Senate Finance Committee
219 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Danielson:

Enclosed is a corrected copy of the testimony of Mr. E.B. Leisenring which was presented on behalf of National Coal Association on September 26, as part of the panel on mining. Changes are minimal, and may be found on pages 72 and 74.

Near the bottom of page 93, Senator Symms asked what the actual loss in dollars might be to the Treasury should the provisions adversely impacting on the mining industry be enacted. Price Waterhouse, who provided NCA much of the data for our testimony told us that such a number was impossible to quantify based on the information available to them. However, based on Treasury numbers and the testimony of the American Mining Congress, based on the study by Arthur D. Little, Inc., a fairly accurate estimation of Treasury income per job can be figured.

In direct response to Senator Symms' question, the following answer may be inserted at the bottom of page 93.

"Mr. Leisenring: Senator, we do not have the precise information you are requesting. And, unfortunately, our Price Waterhouse study can not accurately provide the numbers you seek. However, if I might, I would point out that the Arthur D. Little study commissioned by the American Mining Congress projected a mining and related industry job loss in the area of 400,000. The President's proposal to repeal percentage depletion estimates a revenue gain of about $4 billion over a five-year period. Simple arithmetic indicates that Treasury gains $10,000 for each lost job. How much are unemployment and welfare payments, retraining costs, lost taxes on personal income, etc.? I don't know. I respectfully suggest that it is far more than $10,000 per each potentially unemployed. And, one can't possibly quantify other adverse impacts on the national economy such as the balance of trade deficit, state and local costs, or in addition the personal and family trauma of being thrown out of a job."

If I can be of further assistance, please call on me.

Sincerely,

Robert F. Stauffer

RFS:jg

1130 Seventeenth Street, N.W.
Washington, D.C. 20036-4677
(202) 463-2625

Senator SYMMS. I guess the thrust of my question is that I don't believe Treasury's numbers when they talk about how much revenue they are going to gain. If you look at it industry by industry, they are going to lose enormous revenues to Treasury. We have already lost it, because of the severe international competition. But if we do anything to the Tax Code that makes it any worse for our mining producers and lose more miners, the Treasury is going to have less revenue, not more, and the static numbers that they use at Treasury I think give the Congress a totally erroneous picture of what really is going to happen, notwithstanding and not to mention the national security implications, just the pure dollars and cents.

Do you have figures on that, Mr. Bedell?

Mr. BEDELL. I don't have them on the retraining, relocation, loss side; but I think it is readily apparent that what you say is absolutely correct, because of the small amount the Treasury projects will be gained in revenue from repeal of the depletion allowance. For the hard mineral sector, including coal, Treasury estimates the revenue pickup at something like $200 million a year. And if we are talking about the loss of in excess of 400,000 jobs, that means a yearly revenue gain of only, $500 per job. The offsetting loss of their income taxes and the retraining costs are obviously going to be greatly in excess of the small revenue gain.

Senator SYMMS. Well, to be specific, in my State I asked Hecla Mining Co. to run these numbers of what they thought would happen to Hecla.

I would ask unanimous consent, Mr. Chairman. that I put this in the record at this point. And I will get those figures from my office to put in.

The CHAIRMAN. Without objection.

[The information follows:]

COPY

For [illegible] Symms

June 10, 1985

The Honorable Steven D. Symms
Senator, State of Idaho
509 Senate Hart Office Building
Washington, D.C. 20510

Dear Steve:

In accordance with your recent request, I am forwarding herewith an internal memorandum summarizing a study of the impact of President Reagan's newest tax proposals on Hecla Mining Company.

The study uses our actual earnings performance over the past five years as a basis for a comparison between our tax liability under existing legislation and that under the President's proposal. In our highly cyclical business, we think it important that any such study cover a period of approximately the price cycle in silver in order to be meaningful. We have chosen here to use the five years 1979 through 1983, and we consider the average for this period to be the most important number. We have also assumed that the proposed depletion allowance phase-out would have been completed by the start of this period. We have further assumed that the operating loss carryforwards which affected our actual tax in recent years did not exist, since they are an abnormal situation.

The bottom line is that the latest tax proposal would increase our federal income tax liability by 56%. This is primarily the result of the loss of the depletion allowance. It is an improvement over the proposals first proposed by the Treasury Department, primarily because the latest proposals do not change our ability to expense exploration costs as they are incurred. However, a 56% increase in our federal income tax is going to have a serious impact on our ability to compete in the world mining scene. As you are well aware, this is the arena in which we must compete because silver is a commodity traded world-wide with a price set on a world-wide free market. Although other aspects of the President's tax proposals do impact us, we feel we could live with them if we could retain the present depletion allowance.

Please be assured that we are very much in favor of the idea of tax simplification. We fail to understand, however, why a so-called "tax neutral" tax simplification bill need involve, first, a tax shift from individuals to corporations; and second, a conscious further shift of tax burden from service and other kinds of businesses to those of us in the struggling natural resource industries.

HECLA MINING COMPANY
WALLACE, IDAHO

If you or members of your staff are interested in further details of this study, please feel free to contact Mr. W. J. Grismer, Senior Vice President of Hecla Mining Company, who would be pleased to answer your questions. You are free to use this information in any way that you see fit.

Sincerely yours,

Wm. A. Griffith
Chairman

WAG:jg
Enc: 1
cc: WJG

HECLA MINING COMPANY

June 7, 1985

MEMORANDUM TO: W. A. Griffith

FROM: William J. Grismer

SUBJECT: The President's Tax Proposals

As a comparison, the attached schedule sets out the effect of the new tax proposals compared with actual results on a scale-out for five years - 1979 through 1983 - ignoring NOL benefits and using averaging to get a five-year total. While the computation is rough, it does reflect the effect of the proposals.

The point is, the present law approach gives a five-year total of $12,208,000 (line A) versus the new proposal of $19,102,000 (line B), or an increase of approximately 56%.

The major causes are:

(1) Percentage depletion would be lost (i.e., phased out over five years.)

(2) The comparison reflects the capitalization of 20% of exploration and development expense, which is already required for years after 1984 (as part of the 1984 tax reforms).

(3) The change in depreciation allowances from the ACRS (Accelerated Cost Recovery System) system put into effect in 1981 and the proposed CCRS (Capital Cost Recovery System) system would have only minimal effect on Hecla.

(4) There is an "alternative minimum tax" proposed, but the loss of percentage depletion (comparatively) more or less renders this tax moot in our example, except for the five-year transition period (1986-1990) where we phase out percentage depletion by 20% each year. (The effect of this phasing out is not reflected in our example.)

We can discuss this matter at any time.

William J. Grismer

WJG:skp
Enclosure
cc: ABrown
TTGiles
RHWallace

HECLA MINING COMPANY
COMPARISON OF PROPOSED TREASURY TAX SCHEME
WITH ACTUAL FOR PAST 5 YEARS
(EXCLUDING NOL RELATED ITEMS)

6-7-85

	($000)	5 year totals	1983		1982		1981		1980		1979	
	Per law in effect during those years - Excluding NOLs											
	Taxable income (loss) per return filed		$ -0-		$(9,193)		$(12,736)		$ -0-		$ (4,230)	
	Add back - NOLs		11,774		-0-		-0-		34,482		-0-	
	Restated taxable income (loss)		11,774		(9,193)		(12,736)		34,482		(4,230)	
	Regular tax @ 46%	$ 9,244	5,416	Pref Item	(4,229)	Pref Item	(5,859)	Pref Item	15,862	Pref Item	(1,946)	Pref Item
	Minimum tax - Hypothetical	4,143	783	$(10,639)	963	$(2,190)	74	$(328)	- -	$(12,707)	2,323	$(10,999)
	Investment credit	(1,179)	(735)		(192)		(30)		(216)		(6)	
"A"	Tax payable	$ 12,208	5,464		(3,458)		(5,815)		15,646		371	
	Adjustment - Estimated to reflect the President's Tax Proposals											
	Taxable income (loss) as above - Ignoring NOLs		11,774		(9,193)		(12,736)		34,482		(4,230)	
	Add:											
	Percentage depletion in excess of cost depletion		10,635		1,620		326		12,717		11,009	
	ACRs depreciation		1,785		435		80		- -		- -	
	* Exploration and development expense - Capitalize 20% (Note: 1983 is only increased from 15%)		362		1,927		2,569		810		317	
	Deduct:											
	Estimated CCRS depreciation in place of ACRs		(2,012)		(497)		(88)		- -		- -	
	Dividend paid deduction - 10% of dividends		(281)		- -		(447)		(87)		- -	
	CCRS depreciation on capitalized exploration and development expense		(1,199)		(1,216)		(706)		(221)		(52)	
	Revised taxable income (A)		21,064		(6,924)		(11,002)		47,701		7,044	
	Tax @ 33%		6,951		(2,285)		(3,630)		15,741		2,325	
	or											
	Alternative minimum tax											
	Revised taxable income (A)		21,064		(6,924)		(11,002)		47,701		7,044	
	Add preference items											
	Percentage depletion (already eliminated)		- -		- -		- -		- -		- -	
	Capital gains - Preference portion - Not significant		- -		- -		- -		- -		- -	
	Excess of exploration and development cost expensed - Over 10 year amort.		2,960		5,462		8,801		2,759		1,142	
	Basis for alternative minimum tax		24,024		(1,462)		(2,201)		50,460		8,186	
	Tax @ 20%		4,805		N/A		N/A		10,092		1,637	
"B"	Larger - Tax due	$ 19,102	6,951		(2,285)		(3,630)		15,741		2,325	

*Note - This charge is already law as part of the 1984 Tax Reform Act.

Senator SYMMS. But they estimated that their taxes over the last 5 years would be 56 percent higher than they have paid. Now, they are not making a profit right now, with these depressed metals, but when I inquired and quizzed the managers and the president of the corporation, "What would you do if this tax burden was placed on you right now?" They said, "We would have no choice except to cease operations until the price of metals goes higher, because with losing percentage depletion" and that is the biggest one that affects them, more than the ITC's, even, but with losing that they would have to shut down their operations—not all of them, but many of their operations—and all of the other companies that operate in Idaho have confirmed the same thing to me: they would have no choice.

So, I think that this will be one issue that we surely will win on, because I don't think the other people have an argument. I don't know why they let people down in the bowels of the Treasury come up with these kinds of hairbrained schemes, myself. I never have been able to figure out why allow that to happen. You know, it seems to happen no matter who is in office, that the Treasury keeps wanting to tax everything that they haven't thought of. So, I even hate to come up with a new idea around here, or they will want to tax that, too.

Mr. Chairman, I thank you very much for having this hearing this morning, and I think that the statement of the mining industry certainly speaks very close to home to me, because mining is a substantial segment of our economy in Idaho, and this would be absolutely devastating to the jobs and the people who live in my State if this were passed. I will certainly be here trying to plead a rational decision on the part of this committee, if we ever get to this. I hope it is several years away before we really get to this point.

The Chairman. I can assure you, if we do go to it, he will be here doing just what he says he will do.

Thank you very much. Carl, I am glad you got on today.

We are recessed.

[Whereupon, at 11:38 a.m., the hearing was concluded.]

[By direction of the chairman the following communications were made a part of the hearing record:]

Statement of
Henry D. Forer, C.P.A.
Partner, Deloitte Haskins & Sells
Miami, Florida

On Behalf Of
The Florida League of Financial Institutions
Filed With
The Senate Finance Committee
September 26, 1985

My name is Henry D. Forer and I am Partner-in-charge of services to the savings and loan industry for Deloitte Haskins & Sells, an international public accounting firm. This statement is being filed on behalf of the Florida League of Financial Institutions. The Florida League is a state-wide trade association representing over 140 savings and loan associations and savings banks operating in Florida with aggregate assets approximating $90 billion dollars.

Florida League membership includes both mutual and stock institutions. As mutuals, net income is the only practical source of net worth. Many of the stock institutions are recently-converted mutuals who, as new public companies, now are seeking to establish their identity in the marketplace as solid institutions with a consistent pattern of earnings. Both the stock companies and the mutuals are striving to meet the credit needs, primarily in the housing area, of the residents of Florida, one of the fastest-growing states in the nation.

Although the League supports the overall objectives of fairness, growth and simplicity of the Administration's Tax Reform proposals, we cannot sit idly by without pointing out some of the extremely adverse financial effects of certain provisions of the reform package. These provisions would reduce the net income and net worth of League members at a critical time when savings depositors, regulators and stockholders have these measures of financial integrity under high intensity scrutiny.

The Florida League supports the statements of the other thrift industry representatives appearing before or filing statements with the Committee. Rather than repeating their points, we wish to confine our remarks to the financial statement impact of the reform package. As explained below, we are respectfully disagreeing with certain statements contained in the September 12, 1985 pamphlet of the Joint Committee on Taxation concerning this subject.

The Administration's tax reform proposals contain provisions that will adversely affect the net income and net worth of League members as follows:

1. The total tax impact of the bad debt reserve recapture will be required to be recognized as a current expense.

2. Subject to final conclusions to be reached by the Financial Accounting Standards Board ("FASB"), the increase in the marginal thrift institution tax rate will require an upward adjustment of existing deferred income taxes, thus compounding the financial statement effect of the bad debt reserve recapture.

Bad Debt Reserve Recapture

The bad debt deduction changes contained in the Administration's tax reform proposals will adversely and immediately affect the financial statements of League members. Under the proposals, thrift institutions could no longer use the percentage-of-loans method or the percentage-of-taxable-income method for computing bad debt deductions. Instead, bad debt deductions would be available only as losses occur. Further, previously deducted bad debt reserves would have to be included in taxable income (recaptured) over a maximum 10-year period.

Although the precise recapture calculation is not entirely clear since it would be limited to an amount calculated under methods previously utilized by commercial banks, it can be estimated. In the aggregate, it could approximate $200 million of tax for Florida thrifts and we believe it would have an extremely adverse effect on many individual Florida League members.

Under existing authoritative accounting literature, the total income tax impact of bad debt reserves to be recaptured would be recognized as an expense, based on current tax rates, as of the enactment date of any new legislation. This accounting requirement is immediate, notwithstanding a permissible 10-year period of recapture into taxable income.

Paragraph No. 23 of Accounting Principles Board ("APB") Opinion No. 23 states:

> The Board concludes that a difference between taxable income and pretax accounting income attributable to a bad debt reserve that is accounted for as part of the general reserves and undivided profits of a savings and loan association may not reverse until indefinite future periods or may never reverse. The association controls the events that create the tax consequence, and the association is required to take specific action before the initial difference reverses. Therefore, a savings and loan association should not provide income taxes on this difference.

> *However, if circumstances indicate that the association is likely to pay income taxes, either currently or in later years, because of known or expected reductions in the bad debt reserve, income taxes attributable to that reduction should be accrued as tax expense of the current period;* the accrual of those income taxes should not be accounted for as an extraordinary item. (Emphasis added)

Thus, the tax effects of the proposed recapture of prior bad debt deductions would be recognized in the financial statements as an expense at the enactment date, based upon tax rates currently in effect.

Deferred Income Tax Effect

Under the Administration's proposals, the maximum marginal tax rate of thrift institutions will become 33%. Over the years since 1968, this thrift rate has increased from 19.2% to its present level of 31.3%. Existing deferred income taxes were established using these lower levels of marginal tax rates, pursuant to existing accounting literature.

Paragraph No. 19 of APB Opinion No. 11 states, in part:

> ...The deferred taxes are determined on the basis of the tax rates in effect at the time the timing differences originate and are not adjusted for subsequent changes in tax rate or to reflect the imposition of new taxes...

However, accounting for tax rate changes as a result of the tax reform proposals will depend on the final conclusions reached by the FASB in its current project on income taxes. The FASB has tentatively decided that comprehensive interperiod tax allocation should be continued. However, the FASB favors a liability approach to interperiod tax allocation rather than the deferral method presently used and described above.

Under the liability method of comprehensive interperiod tax allocation, deferred taxes would need to be adjusted based on tax rates expected to be effect when the liability is paid.

Paragraph No. 20 of APB Opinion No. 11 states, in part:

> ...The estimated amounts of future tax liabilities and prepaid taxes are computed at the tax rates expected to be in effect in the period in which the timing differences reverse. Under the liability method the initial computations are considered to be tentative and are subject to future adjustment if tax rates change or new taxes are imposed.

Accounting for a change to the liability method would be subject to any transitional guidance included in any ultimate pronouncement issued by the FASB.

To summarize, under existing authoritative accounting literature, the proposed increase in the maximum marginal income tax rate would require no current accounting recognition. The deferral method of comprehensive interperiod income tax allocation emphasizes rates in effect at the time the timing differences originate. Deferred taxes are not adjusted for any subsequent changes in tax rates.

However, under the liability method tentatively decided on by the FASB, the increase in the maximum marginal income tax rate would require an upward adjustment, as of the enactment date of any new legislation, of existing deferred taxes. We believe these upward adjustments would be significant and, coupled with the tax effect of the bad debt recapture, would seriously erode not only net income but also net worth, which is critical to members of the Florida League of Financial Institutions.

Joint Committee Analysis

On September 12, 1985, the Joint Committee on Taxation issued a pamphlet entitled, Tax Reform Proposals: Taxation of Financial Institutions (JCS-38-85), which discusses the Administration's proposals. We respectfully disagree with a number of statements contained in the pamphlet including the following:

> 1. "The financial accounting methodology for thrift institutions is the same as for banks." (p. 24)

The above statement, which was made in the context of the bad debt deduction, is clearly erroneous. We have previously (see page 3) cited those provisions of paragraph 23 of APB Opinion No. 23 which classify the bad debt reserve of a savings and loan association as a permanent difference. Banks were not included in APB Opinion No. 23 and treat differences between bad debt reserves for financial accounting and income tax purposes as timing differences (see AICPA, Audits of Banks, (1983), p. 94). Accordingly, the financial accounting methodology for thrift institutions is clearly not the same as for banks.

We also respectfully disagree with the following statements:

> 2. "Some thrift institutions have followed financial accounting procedures which treat the tax deduction for bad debts under the percentage of income method as a reduction in their effective tax rate rather than as a timing difference. As a result, no amounts currently exist in their deferred tax reserve accounts to cover the additional tax resulting from the Administration's proposal to recapture a portion of the bad debt reserve...[t]he problem lies not with the Administration's recapture proposal, but rather with the

> failure of certain thrift institutions to show a deferred tax liability on their balance sheets. Thus, it is argued, the problem is one of a failure to follow adequate accounting procedures in the past, and not a problem of tax policy." (p. 28-29) [emphasis added]

We believe the use of words "some" and "certain" to characterize thrifts which have not established deferred taxes on bad debt reserves is erroneous. Indeed, we do not know of a single instance where deferred taxes were established for permanent differences. Reference is again made to existing generally accepted accounting principles as set forth in paragraph 23 of APB Opinion No. 23, which states:

> "Therefore, a savings and loan association should not provide income taxes on this difference." [emphasis added]

We therefore submit that the problem is not one of a failure to follow adequate accounting procedures in the past but is a tax policy matter that must be addressed by the Congress.

STATEMENT OF
THE EXPANDED SHALE, CLAY AND SLATE INSTITUTE
TO THE
COMMITTEE ON FINANCE, UNITED STATES SENATE

September 26, 1985

Mr. Chairman and Members of the Committee:

The Expanded Shale, Clay and Slate Institute appreciates the opportunity to present its views on President Reagan's tax proposals being considered by the Committee.

The Expanded Shale, Clay and Slate Institute is an industry association representing approximately 80% of the United States producers of rotary kiln lightweight aggregate. Rotary kiln lightweight aggregate is produced by burning clays, shales and slates in a rotary kiln. Burning expands and stabilizes these raw materials to make them suitable for use as a lightweight aggregate. Almost all of the lightweight aggregate produced in the United States is sold as concrete aggregate and used to make lightweight concrete products such as structural concrete, roof slabs, concrete masonry block units, insulating concrete and precast shapes.

The Institute strongly supports certain elements of the President's tax reform proposal. However, we believe some elements of the proposal constitute a serious threat to the economic vitality of the lightweight aggregate industry.

The economic strength and viability of the lightweight aggregate industry is essential to the Nation's continued industrial and economic well-being. The use of lightweight aggregate in the construction of buildings, housing and our Nation's highways and bridges has resulted in tremendous savings of steel and other critical materials and minerals. In addition, the reduction in design requirements of buildings and highways made possible by the use of lightweight aggregate is of untold benefit. For example, lightweight aggregate has been used in such notable structures as the roof of the United States Capitol Building, the Chesapeake Bay Bridge, the World Trade Center in New York City and the two tallest concrete structures in Chicago and Houston. In the reconstruction of the United States Capitol Building lightweight concrete, rather than ordinary concrete, was used for the roof slabs because the building's supporting structures could not carry the tremendous weight of ordinary concrete. In the construction of the Chesapeake Bay Bridge, spanning 4.3 miles of open water, lightweight concrete, rather than ordinary concrete, was used for the bridge deck. By using lightweight concrete instead of ordinary concrete the dead weight of the deck was reduced by more than three million pounds per mile, resulting in a substantial saving in structural and reinforcing steel.

A federal tax system that recognizes the importance of the lightweight aggregate industry to the Nation's industrial and economic well-being is essential to the industry's survival and the Nation's economic vitality.

The present federal tax system recognizes the importance of the lightweight aggregate industry and provides many tax incentives designed to encourage the development and production of lightweight aggregate. Percentage depletion is foremost among these incentives.

The basic purpose of the percentage depletion allowance has always been to insure an adequate of supply of the Nation's national resources at a reasonable cost to the consuming public. Provision for the percentage depletion allowance in the tax law illustrates that minerals in the ground have no usefulness to the public unless someone has the courage and persistence to assume the risk, and make the substantial investments of capital essential for the discovery and production of certain vital minerals, such as clay, shale and slate used in the production of lightweight aggregate. A phase out of the percentage depletion allowance would eliminate the financial incentives necessary to justify the efforts and expenses needed to discover shale, clay and slate deposits suitable for the development and production of lightweight aggregate.

The discovery, development and production of shale, clay and slate deposits suitable for lightweight aggregate is a capital intensive industry. The percentage depletion allowances helps to finance these capital needs and has generally been reinvested to: (i) develop new deposits of clay, shale and slate; (ii) develop and modernize new mineral processing technology; and (iii) develop more cost efficient environmental controls in mining technologies. A continuation of percentage depletion is essential to the lightweight aggregate industry.

Producers of lightweight aggregate analyze their potential return on investment (ROI) in deciding whether to invest in a new deposit of clay, shale or slate and the facilities necessary for development and production. Percentage depletion is a significant component of the ROI factor and has become an integral part of the economics of the lightweight aggregate industry. A phase out of the percentage depletion allowance will substantially reduce and possibly eliminate the after-tax ROI on many existing and planned projects to develop and produce lightweight aggregate. This reduction in ROI will discourage outside investors from investing in the lightweight aggregate industry and reduce the availability of internally generated working capital for new investments. This reduction in after-tax ROI and internally generated working capital will result in: (i) reduced production of lightweight aggregate; (ii) reduced exploration for suitable clay, shale and slate deposits and development of lightweight aggregate; and (iii) reduced numbers of highly paid skilled jobs in the lightweight aggregate industry.

A phase out of percentage depletion may signal the end of an industry in America that is flourishing in the Soviet Union. Since 1970, only one new lightweight aggregate plant has been constructed in the United States. During the same fifteen years the Soviet Union has built many new lightweight aggregate plants. The lightweight aggregate industry has witnessed a drastic decline in the development and production of lightweight aggregate. The decline is due to rising energy and environmental control costs and to increased imports of lightweight aggregate. The Soviet Union, in particular, has encouraged the production of lightweight aggregate because of its many outstanding qualities like energy savings, fire resistance and durability. The lightweight aggregate industry must have percentage depletion to remain competitive with an ever increasing foreign lightweight aggregate industry.

It is generally recognized that mining is an extremely risky business. Because of the risks and the capital intensive nature of the mining business, most companies are unwilling to invest their own capital. Despite this fact, substantial investments have been made by producers of lightweight aggregate to modernize plants and equipment and to develop more cost efficient mining technologies. These investments of capital have been made with the expectation that the tax laws would continue to provide essential incentives, like the percentage depletion allowance, to help achieve an adequate financial return on these long-term fixed investments. Congress' enactment of the Mining and Minerals Policy Act of 1970 and the National Critical Minerals Act of 1984, bolstered this expectation by reaffirming that development and availability of critical minerals and materials are essential to the economic well-being and industrial capacity of the United States. The proposed elimination of the percentage depletion allowance directly conflicts with Congress' existing mineral policy since elimination of percentage depletion will reduce the number of lightweight aggregate plants in this country. This apparent conflict in Congressional policy is irreconcilable. The percentage depletion allowance must continue to be an integral part of our national minerals policy.

The percentage depletion allowance is a sound and effective financial incentive for mineral exploration and development in a high risk and capital intensive industry. Our nation, our heavy industry, and our military strength depend on stable and available mineral wealth. Without percentage depletion the mining industry would not be what it is today. Percentage depletion is one of the principal foundations of our economic, fiscal, and tax policies and has helped support the economic and military strength of the Nation. The incentive and support provided by the percentage depletion allowance should not be eliminated.

M

LAW OFFICES
McGLINCHEY, STAFFORD, MINTZ, CELLINI & LANG, P.C.

DERMOT S. McGLINCHEY
SAMUEL LANG
GRAHAM STAFFORD
DONALD R. MINTZ
DANDO B. CELLINI
DAVID A. LANG
COLVIN G. NORWOOD, JR.
JOHN E. GALLOWAY
DAVID S. WILLENZIK
ROBERT N. HABANS, JR.
E. EDWIN SCHMELZER
WILLIAM F. BOLOGNA
J. MICHAEL JOHNSON
FREDERICK R. CAMPBELL
JAMES M. TOMPKINS
B. FRANKLIN MARTIN, III
WARNER H. ANTHONY, JR.
E. FREDRICK PREIS, JR.
HENRI WOLBRETTE, III
LEOPOLD Z. SHER
WILLIAM V. DALFERES, JR.
MICHAEL J. MAGINNIS
MICHAEL T. PULASKI
WAYNE J. FONTANA
PETER L. HILBERT, JR.
CONSTANCE CHARLES WILLEMS
ERNEST P. GIEGER, JR.
DONALD J. ANZELMO
PAUL M. BATIZA

MICHAEL R. SISTRUNK
THOMAS J. ANZELMO
STEVEN F. KLEIN
SANDRA MILLS FEINGERTS
BENNET S. KOREN
RALPH J. ZATZKIS
JAMES M. FANTACI
SUZANNE P. KEEVERS
KENNETH H. LABORDE
MAUREEN O'CONNOR SULLIVAN
TIMOTHY F. BURR
SUSAN WHITTINGTON LEIDNER
KATHLEEN A. MANNING
J. FORREST HINTON
KENNETH A. WEISS
JOHN GREGORY ODOM
JAMES D. MORGAN
MICHAEL S. MITCHELL
ROBERT B. MITCHELL
ROBERT P. CHAMNESS
BRUCE O. JOLLY, JR.
GLENN P. HARE
ELWOOD F. CAHILL, JR.
RICHARD L. DUNCAN
MARK E. HAUCK
ELLIS B. MUROV
DEBRA J. FISCHMAN
MICHAEL S. GUILLORY
LANCE S. OSTENDORF

STANLEY L. RENNEKER
MICHAEL W. [illegible]
RICHARD P. RICHTER
AVERY T. WATERMAN, JR.
MARIE A. MOORE
ANTHONY J. ROLLO, JR.
SIDNEY J. HARDY
LINDA S. HARANG
VICTORIA L. KNIGHT
EVE B. MASINTER
PAMELA L. HERSHEY
MICHAEL X. HOLLOWAY
TIMOTHY P. HURLEY
JEFFERY P. [illegible]
GENE W. LAFITTE, JR.
GREGORY J. McDONALD
STEPHEN W. RIDER
ROY J. RODNEY, JR.
ERIC A. SHUMAN
WAYNE T. MILLAR
ARTHUR B. [illegible]
WINTHROP C. GARDNER
JOHN W. SINDERS, JR.
MICHAEL J. KINCADE
ARTHUR H. LEITH
DAVID J. SHEA
DAVID L. BARNETT
JOHN F. SHREVES
RUDY J. CERONE

LAW CORPORATION
LOUISIANA AND DISTRICT OF COLUMBIA BARS
DISTRICT OF COLUMBIA BAR
DISTRICT OF COLUMBIA, MARYLAND AND VIRGINIA BARS
NOT YET ADMITTED IN LOUISIANA
ALL OTHERS LOUISIANA BAR

SUITE 5100
2000 PENNSYLVANIA AVE., N.W.
WASHINGTON, D.C. 20006
TELEPHONE (202) 872-1700
TELECOPIER (202) 822-0657

IN NEW ORLEANS
643 MAGAZINE STREET
NEW ORLEANS, LOUISIANA 70130
TELEPHONE (504) 586-1200
TELECOPIER (504) 596-2800
TELEX 584327
CABLE MACSTAM

LAKE PROVIDENCE, LA. AFFILIATE
VOELKER, RAGLAND & CRIGLER, P.C.
405 MORGAN STREET
LAKE PROVIDENCE, LOUISIANA 71254
TELEPHONE (318) 559-1200
FRANK VOELKER, JR.
WILLIAM B. RAGLAND, JR.
JAMES C. CRIGLER, JR.

PLEASE REPLY TO:

The Washington Office

September 27, 1985

Senator Bob Packwood
Chairman
Senate Finance Committee
United States Senate
SR-259 Russell Senate Office Building
Washington, D.C.

Re: Statement of Bruce O. Jolly, Jr. and John Ostby for the Record of the Committee on Finance of the United States Senate on the President's Tax Proposal to the Congress for Fairness, Growth, and Simplicity

Dear Senator Packwood:

Enclosed is a statement submitted by Bruce O. Jolly, Jr., of McGlinchey, Stafford, Mintz, Cellini and Lang, P.C., New Orleans and Washington, D.C. and John Ostby, of Ostby and Nealon, Alexandria, Va. on the President's proposal to tax the income of all credit unions that have more than five million dollars ($5 million) in member savings.

I am the Chairman of the ad hoc Subcommittee on Taxation of the Credit Union Committee of the American Bar Association and represent credit unions throughout the United States. Mr. Ostby served as General Counsel of the National Credit Union Administration under former Administrators Nickerson and Montgomery and Chairmen Connell and Callahan. Mr. Ostby is currently the Chairman of the Credit Union Committee of the American Bar Association. This statement, however, is not submitted on behalf of the American Bar Association, but rather represents the views of experts familiar with credit unions and their role in the financial industry.

It is with pride that we report that credit unions, as unique financial intermediaries, have adapted successfully to the deregulated market — even led the way — without losing their identity. Likewise, it is with concern for their future that we review the proposal to tax these same institutions, the results of taxation on other previously tax-exempt entities, and the arguments for and against the change in the tax status of the nation's credit union. Finally, we evaluate the probable consequences of taxing credit unions.

Present Law

The Tax Code presently provides for the tax-exempt status of credit unions in two discrete sections of the law — Section 501(c)(1) for federal credit unions and Section 501(c)(14) for state-chartered credit unions. The history of these exemptions has been already well-documented in the submissions by two trade associations to this committee. However, we would like to highlight the salient qualities of credit unions that provided Congress with the yardstick for establishing the policy objectives that underlie the current tax-exempt status of the nation's 18,000 credit unions. Although these objectives were first recognized in the Tax Acts of 1937 and 1951, these qualities are still viable today and support the same policy decisions concerning the tax-exempt status of all credit unions.

- First, credit unions were and are non-profit enterprises.
- Second, credit unions were and must, by law, remain true mutual entities with member participation in their governance.
- Third, credit unions must, regardless of size, continue to conduct their operations in a manner dedicated to meeting the needs of their members and that in all respects fulfills the societal goals that Congress originally endorsed when it accorded credit unions their present tax-exempt status.
- Finally, Congress itself must consider the overriding question, "If we change a fundamental tenet of credit union operation through the Tax Code, would we have to recreate these entities tomorrow?"

The Proposed Change

The President has proposed the repeal of the tax-exempt status for credit unions with assets in excess of $5 million. The proposal would tax "large" credit unions under the same rules that apply to other thrift institutions.

The proposal would leave unchanged, for the present, the federal tax-exempt status of those credit unions with less than $5 million in assets.

The proposed effective date would be January 1, 1986.

The President's Arguments in Support of the Proposed Change

The President's proposal to repeal the tax-exempt status of more than 2,000 of the nation's credit unions concludes that "because of their tax exemption, credit unions enjoy a competitive advantage over other financial institutions such as commercial banks and savings and loan associations."

That statement alone, however, does not articulate sufficiently the underlying Treasury analysis that must have preceded the conclusion. Rarely do such sweeping changes in tax policy come to the fore without a broader underlying rationale.

The proposal notes that credit unions have grown and that their share of the consumer loan and savings market has increased as a result of "expanded powers" and their "tax-exempt status." Most telling, however, is the initial statement that under current law, credit union income is exempt, whether distributed or "retained."

The articulated reasons for changing the tax-exempt status of credit unions, therefore are:

- o Credit unions exercise many of the same powers as banks and thrifts.
- o Some credit unions are "large."
- o Retained credit union earnings escape taxation -- until the credit union is dissolved.

Arguments For and Against the Proposal

Even if the foregoing conclusions were entirely true, the justification for modifying the policy objective inherent in the preferential treatment of credit unions is not considered, much less answered, by these statements.

We are confident that members of the Finance Committee, the Congress and the Treasury Department share our belief that credit unions operate in a manner distinctly different from the banks and thrifts to which their consumer lending powers are so often compared. Other submissions to this committee are replete with examples of compassionate behavior exhibited by credit unions toward credit union members not demonstrated by other financial institutions serving the same market, at the same time, and under the same circumstances.

It is important, therefore, to understand why credit unions consistently be have differently from other financial institutions. The true policy issue, which Congress must consider, is whether credit unions are unique because of their structure or because of their tax-exempt status. If it is the latter, then the Treasury proposal weighs much heavier on the side of fairness.

The question of taxation of "large" credit unions is significantly different from the debate surrounding the question of, for instance, the deductibility of state and local income taxes or the structure of the investment tax credit. The latter involves degree of taxation; the former implicitly indicates that the credit union movement no longer performs the singular function that Congress originally designated credit unions to perform.

To suggest that size alone is an appropriate basis for change in the tax law is no more appropriate to credit unions than to suggest that large universities with huge endowments have somehow strayed from the ideals that provide the basis for the exemption of educational institutions. No, the analysis must focus on the policy determinations that originally afforded credit unions their tax-exempt status. We believe that it is the unique structure of credit unions that prompted Congress to grant them a tax-exempt status and that the determination is still a viable tax policy consideration in 1985.

The factors that distinguish credit unions from the banks and thrift institutions to which they are so frequently compared are numerous. These distinctions between credit unions and thrifts are founded in law and translate into the operational differences that have historically supported the present tax-exempt treatment of credit unions. Specifically, credit unions —

- Are non-profit entities (while other financial institutions operate for profit).
- Must limit membership to individuals with a common bond.
- Must deal solely with members.
- Are true mutual institutions — with each member ensured of an equal voice in the operation of the credit union. (Federal law prohibits cumulative voting or the assignment of voting rights to an existing board of directors as part of the membership agreement.)
- Shares are equity — not deposits — and that treatment is reflected in their priority in liquidation.

- Must depend on volunteer officials. Only one board member may be compensated as a board member. The credit union manager may serve on the board, but is compensated as a credit union employee not as a board member. All other board and statutorily required committee members must be unpaid volunteers.

- Do not serve the general public. Even with multiple groups in the same field of membership, the process requires each participating group to have the requisite identity of occupation, association, or residence within a well-defined geographic area that has been unchanged for 50 years.

- Do not make commercial loans. Although the types of consumer loans authorized have changed in the past decade, major areas of lending activity remain without the lending authority of the nation's credit unions.

- Are restricted in their investment authority, ensuring that credit unions remain dedicated to the fundamental goal of providing a low cost source of funds to their members. Even in time of low loan demand, credit unions cannot seek many investment opportunities that would allow them to earn higher yields and attract rate-sensitive funds.

- Have limited access to outside capital sources. This inability to raise capital from external sources is one of the most significant limitations facing credit unions.

- May, generally, not accept deposits. All accounts are legally "shares" and unlike counterpart "mutual" thrift institutions, no debtor-creditor relationship arises between a credit union member and the credit union when a deposit is made.

- May invest only 1% of their assets in service organizations providing services to the credit union. The inability to tap outside capital sources again limits operations.

- May lend only 1% of their assets to their service organizations.

- Members may not vote by proxy.

- o Must permit members to appeal adverse loan decisions either to the board of directors or the credit committee.
- o May authorize interest refunds to borrowing members.
- o Must have a supervisory committee with power to suspend any officer.
- o Must conduct routine audits. The supervisory committee is required by statute to verify accounts at least once every two years.
- o Must make statutorily required transfers to reserves. These required transfers are ironically castigated in the President's proposal as unfair because they are not taxed even though they represent a congressional determination that they are necessary for the safety and soundness of the institution.
- o Are required to pay dividends on all share balances when the minimum par value of shares exceed $5.
- o May expel members.
- o Are not subject to tax, other than real property and tangible personal property taxes to the extent levied on similar property held by other business.
- o May exercise only limited non-discretionary trust powers.
- o May be allotted space in federal buildings where available to serve federal employees.
- o May issue share drafts, not checks — legally distinct because they are not drawn on a deposit account.

The majority of these restrictions on credit unions are found in the state statutes regulating state-chartered credit unions, as well as in the Federal Credit Union Act. The unmistakable conclusion must be that, notwithstanding the superficial appearance of similarities between the consumer powers of credit unions and other financial institutions, credit unions are statutorily mandated to be --

- o Non-profit
- o Democratic, mutual institutions

- o That serve only specific groups in a field of membership
- o With statutorily limited authority to raise external capital, invest resources, or lend funds.

With the understanding that credit unions are structurally different from their financial institution counterparts, Congress has before it ample evidence of the unique behavior that that structure generates. The role that such member-oriented financial institutions play in American society is best recalled by the Jimmy Stewart movie "It's A Wonderful Life" in which the town in the middle of the Depression stood together to save its building and loan from threatened insolvency.

The early history of the taxation of thrift institutions also provides a meaningful basis for evaluating the potential impact of the present proposal on the nation's credit unions. Thrift institutions were originally designed to be philanthropic rather than profit-oriented. The dual purpose was to provide a safe haven for an individual's (member's) savings and simultaneously to supply a source of funds for financing residential loans. Due to the high priority Congress placed on residential construction and thrift, savings and loans and savings banks were exempted from income tax when the first Revenue Act was passed in 1913. The 1913 Act specifically excluded "mutual savings banks not having capital stock" and "domestic building and loan associations."

The 1939 Internal Revenue Code provided a similar tax exemption for "domestic building and loan associations substantially all of the business of which is confined to making loans to members." All transactions of early domestic building and loan associations were confined to members. An individual had to be a shareholder of the association to participate in its benefits. Thus, members were both borrowers and lenders. The rationale for the associations' tax-exempt status was that interest paid by shareholders-borrowers on loans was effectively being returned to them in the form of "dividends" on their accounts. As thrift institutions continued to develop both in size and complexity, however, pressures mounted in the financial community to bring thrifts under federal taxation. The goal was to work toward "equitable" taxation of all financial intermediaries.

The Depression caused significant economic losses for banks, savings banks, and savings and loans. Credit unions faired better during the Depression because as cooperatives, its member-owned shares were "scaled-down" rather than liquidating a credit union. The members' savings shrank, but the mutual entity survived. In other words, credit union members realized equity participation in their savings institution.

The 1930s also marked the beginning of the erosion of other thrift's tax-exempt status. Prior to 1932, "dividends" received from savings and loans on accounts were nontaxable up to $300 per person. The Revenue Act of 1932 repealed this special exemption by treating these dividend payments like interest income from a bank deposit. The Public Debt Act of 1942 went a step further by repealing the exemption from income tax granted to distributions from federally-chartered savings and loans. Thus, by 1942, savings and loan dividends paid to depositors were fully taxable even though thrifts themselves remained exempt.

Mounting political pressures for "equitable taxation" of financial institutions forced Congress to pass the Revenue Act of 1951. The 1951 Act bought an official end to the tax-exempt status of the savings and loans and savings banks by subjecting them to tax laws applicable to all corporations.

Even after adoption of the 1951 Code, domestic building and loan associations were allowed tax deductions for loan reserves that greatly exceeded their actual losses. This deduction for building and loan associations was an outgrowth of Congress' recognition of the high risks involved in making long-term mortgage loans and the need to provide funds to finance the nation's housing requirements. The effect of this benefit was to increase greatly the associations' after-tax yield on investments and loans.

The 1962 Revenue Act instituted a number of changes in the tax formula for savings and loans that can only be characterized as staggering. The effective tax rate for savings and loans jumped from less than 1% in 1962 to 16% by 1963. In contrast, the effective rate on mutual savings banks, which were not subject to the same restrictions on lending as savings and loans, changed very little. The primary reason for the marked difference was the saving banks' ability to hold large amounts of tax-exempt securities while still obtaining a substantial bad debt deduction. With the '69 and '81 Acts, the pressure to tax the earnings of institutions with statutorily limited purposes has increased even more.

As this brief overview shows, growth may have contributed to the determination to tax savings and loans. However, that decision appears to have been based more on their drift away from a nonprofit, mutual orientation and a dedication to lending only to members.

In turning to the question of probable consequences of a change in the exempt status of credit unions, the Finance Committee and ultimately Congress must confront the truly hard issues.

We foresee three major effects if Congress elects to tax credit unions. First, we believe that credit unions will not fail to notice the difficulties experienced by limited purpose thrifts in the years since 1951. Thus, we predict substantial pressure to change the very structure that distinguishes today's credit unions from other financial institutions.

The second consequence is that the services offered by credit unions will change. Credit unions will be forced to raise loan interest rates or service charges, or both, to retain the safe levels of capital needed by today's financial institutions and deliver the same types of services demanded by members. Although there will be even greater pressure to decrease operating expenses, we do not believe that credit unions will be able to attract and retain qualified board and committee members without providing adequate compensation.

Finally, the most significant change would result from the credit union need to seek external sources of capital to maintain stability, provide for growth, and retain their vitality in a competitive, deregulated marketplace.

Conclusion

Answering the question — whether the tax-exempt status of credit unions or whether their structure makes them unique — is to pose a question best answered by history. Clearly, the structure is unique. It is a reflection of their historic purpose and the fundamental policy determination made in granting the original exemption.

Unlike the thrifts in the 1950s, credit unions in 1985 have not departed from the fundamental structure and purposes that warranted a reaffirmation of their present tax treatment in 1937, 1951 and 1978. Also, the fact that taxation will affect only that portion of income actually retained in reserves needed to ensure safety and soundness should not lead Congress to the conclusion that the impact will be minimal.

If Congress elects to end the special tax status of the nation's credit unions, it must recognize that the change will create substantial pressures to fundamentally alter the structure of these financial intermediaries.

We appreciate the opportunity to express our views on this matter.

Very truly yours,

Bruce O. Jolly, Jr., Esq.

John L. Ostby

John Ostby, Esq.

BOJ/hrh/AA/#107

STATEMENT

of the

MINING & RECLAMATION COUNCIL OF AMERICA

For the Hearing Record of the

SENATE FINANCE COMMITTEE

On the Impact of the President's Tax Proposals
on the Mining Industry

September 26 1985

DRG/#0330A

The following statement is submitted on behalf of the Mining and Reclamation Council of America (MARC) for the hearing record of the Senate Finance Committee on the impact of the President's tax proposals on the mining industry.

The President's tax proposals for "Fairness, Simplicity, and Growth" contains a series of provisions designed to raise billions of dollars over the next few years. Several of these will adversely impact the coal industry. While overall the proposal is a laudable attempt to impart "fairness" to the tax code, the reforms would reverse a number of longstanding industrial policies.

Much of the revenue needed for the tax redistribution components of the plan would be raised by taking back production and capital formation incentives for basic industries as coal. Those incentives are critical to enabling the U.S. to continue to be the most efficient, safe, and environmentally sound coal producer in the world.

At the outset it must be noted that the coal industry already pays more than its fair share of taxes. In addition to its federal income taxes the coal industry also pays over $700 million per year to the federal government in special taxes on the coal industry-the black lung and surface mining tax-in addition to royalty payments on federal coal and state income and severance taxes.

For the past several years many of the coal industry's capital investments have been only marginally profitable--in part due to the one or two major tax provisions that encourage exploration and development. In this regard, the coal industry is acutely concerned by the President's proposal to phase out percentage depletion for coal and practically eliminate expensing of exploration and development costs. Changes to these provisions would compound the tax burden on the coal industry as would proposals, to a lesser degree, to eliminate the capital gains treatment for coal royalties and the accural of reclamation reserves.

Coal's effective 8.5 % depletion allowance is already low compared to other minerals, which receive allowances as high as 20 %. While all domestic minerals are extremely important to the Nation's welfare, none are more important to the economy and our energy independence than coal. As the Committee is well aware, the Congress, through the decade of the 1970's - in response to major "oil shocks" - established a national policy to utilize domestic resources and reduce the importation of energy from abroad to the maximum extent feasible. This policy would be seriously jeopardized by the President's proposed changes in tax treatment of the coal industry.

The coal industry has been severely impacted by the current worldwide recession. Both domestic and foreign production are down in 1985. Hundreds of mines are closed and thousands of miners continue to be out of work. Artifically low gas prices, the oil glut, and high transportation and environmental compliance costs for coal are making coal less competitive with other fuels. Any additional tax burden or change in percentage depletion will exacerbate the problems facing the entire coal industry. Both small and large producers will be impacted, since depletion is figured on a mine-by-mine basis.

In spite of the current downturn in coal markets, the coal industry must begin now to accommodate expansion and growth for the future to meet the Nation's projected needs. By conservative estimates, the coal industry will require capital investments of at least $30 billion in constant dollars between now and the year 2000. This amount is inordinately larger than the current total industry capitalization of $20 billion. As outlined below, the proposals under consideration will make the needed capital increasingly scarce and far more expensive.

While capital costs vary according to the terrain and the depth of the seam, it is generally accepted that the capital cost to install a new mine, exclusive of the cost of coal, averages about $65 per ton of annual production. This figure does not include the substantial administrative costs prior to start-up, such as securing permits, surveys, feasibility studies, and other related costs. Thus, a medium-sized mine, with a capacity of one million tons a year, represents well over a $65 million capital expenditure by the time it actually begins commercial production. These new mines will mean thousands of additional jobs for miners.

Production costs are also skyrocketing. Total industry production costs increased over 100 percent during the period 1975 to 1984. The cost of machinery alone was up over 125 percent during that period. In spite of this trend, prices for coal have increased by a smaller percentage. In fact, in constant dollars the national average minemouth price of coal has declined by 18 percent over the same period. The coal industry has survived this shrinking margin between costs and prices by making the necessary investments to increase productivity. Over the past seven years production per man hour has increased 175 percent in underground mines and 145 percent at surface mines. This impressive record of productivity increases is largely the result of investing internally generated working capital in improved technologies for extracting coal and the acquisition of more productive equipment to be used in the mines. Elimination of percentage depletion for coal would directly and significantly reduce the availability of working capital for such investments in the future, thereby threatening future productivity increases in the coal industry.

Coal must compete in the money market for its capital requirements. Given the high risk nature of coal mining, the industry's cyclical nature, and the present low profit margin, any reduction in tax incentives that have a current or future adverse impact on profits will make capital for opening new mines less available and more expensive.

Coal operators, as any other business, look at their potential return on investment (ROI) in determining whether to invest in a new mine and related facilities, and, as any other businessman, the coal operator's bottom line is making a decision based on the after-tax ROI. Percentage depletion, and the other incentives mentioned earlier, are significant components of ROI and a major source of cash flow for investments in productivity improvements, research in more cost efficient environmental compliance and mining technologies, and new mines. By itself, and in conjunction with other proposed tax changes mentioned herein as well as the Administration's proposal to increase the black lung excise tax by 50 percent, the after tax ROI on coal mine projects promises to be substantially lessened and in many cases, eliminated.

This reduction in ROI will both decrease the attractiveness of the coal industry to outside investors and substantially reduce the availability of internally generated working capital for new investments. As a consequence, the cost of capital for the coal industry will increase; the industry will stagnate and begin to shrink; and, the number of highly-paid skilled jobs in the mining industry will be reduced as investment capital and operators leave the industry and pursue ventures which promise a higher ROI.

As investment in technologies to increase productivity and in new mines shrinks, the production cost per ton on coal will increase relative to competitors to the United States coal industry in both domestic and international markets. This will result in - (1) increased coal and oil imports into the U.S. for power generation; (2) increased electricity imports from Canada; (3) a decline in the U.S. share of the world coal markets and a reduction in coal's contribution to the balance of trade deficit; and (4) higher prices for domestically produced coal than would otherwise have occurred.

Energy Secretary Herrington, in testifying recently before the Senate Finance Subcommittee on Energy and Agricultural taxation stated that:

> "The net effect of the President's tax proposal on the coal industry...will mean a higher level of tax liabilities for both existing and future coal mines, with an eventual price increase of perhaps 5-10% on coal from new mines...."

The Secretary's observations, based upon an analysis we have not had the opportunity to review, would appear to be generally accurate. They reflect, however, a fundamental misunderstanding of the coal market. The price of coal is determined by the economic law of supply and demand. So long as oil is available for base and peak load power generation at stable or declining prices; foreign coal is available at prices as much as 30% below domestically produced coal in selected markets; and imported electricity is available at prices below the cost of power generation domestically, the prices for coal cannot rise since the market will not purchase it at a higher price.

As a consequence, coal operators will have to absorb the "higher level of tax liabilities" the Secretary noted. Both their after tax margins and internally generated working capital will be reduced with the effects, outlined above, the expected result.

The impact of these changes, while they will effect all coal operators, will be acutely felt by the small, independent coal operators MARC represents. Generally, these operators, which comprise the overwhelming majority of operators in the industry are privately owned and almost exclusively dependent on internally generated cash flow for capital. The President's proposals will dramactically decrease the cash flow available to such operators.

As a consequence, should the proposed changes be effected, the Committee should anticipate an acceleration of the trend toward concentration in the coal industry. According to the Energy Information Agency, small companies have suffered a dramatic decline in nationwide production share in recent years. Between 1977 and 1983, companies producing less than 200,000 tons realized an overall production share decline of 35%. Producers in the 200,000 to 500,000 ton range lost nearly 9% of production share, while companies mining 500,000 tons and up realized a 45.3% increase in their percentage of overall production. During this six-year period, nationwide coal production grew by over 13%. Ten years ago there were over 7,000 coal producing companies in the U.S...today there are less than 3,600.

Other elements of the President's proposal, mentioned earlier, will also have a disproportionate impact on smaller operators. The deduction of exploration and development costs, which are expenses that a coal industry must pay at the time they are incurred and largely labor intensive, are also a significant source of cash flow. It makes no sense that a high-tech company can deduct the salary of a scientist to refine a micro-chip while a coal operator is not permitted to fully expense the wages of a worker constructing a road to a new mine. It's ironic that the Interior Department is criticized and chastised for not having obtained sufficient data from the industry prior to leasing federal coal while the Treasury Department promotes tax policies to discourage development of exploration data.

The President's proposal also proposes to repeal what's left of capital gains treatment for coal royalty income and the limited ability of an operator to deduct accrued reclamation expenses. Less than one year ago, in this very room, the conferees on the 1984 Tax Act eliminated a 30-year policy of capital gains treatment for coal royalty income between related parties and legislatively reversed a unanimous opinion of the Tax Court that coal operators, as accrual basis taxpayers, are entitled to deduct liabilities when they arise as they are required to accrue income when it is earned.

Both actions contained limited grandfather provisions to avoid destroying the economics of previously entered contracts. The President's proposal would abrogate those agreements in which the Treasury Department was a party. While the dollar impact of those proposed changes may appear insignificant in the context of the President's proposal, their repeal would have a significant adverse impact on many operators and in some situations would make a contract originally negotiated to make a profit into a loss. The repeal of the accural provisions would, as depletion, result in directly reduced cash flow and availability of working capital.

In conclusion, MARC would like to point out that the provisions of the tax code referenced in this statement are an integral part of our Nation's industrial, economic, and energy policy. Any modifications of these provisions must closely be scrutinized in light of the ramifications these tax policy changes will have on other national policies and national security. The proposed changes will result in decline of the projected growth of the domestic coal industry; a decline in number of available skilled jobs in the relatively high wage coal industry; a decline in economic activity in the historic coal mining regions of the Nation; and, a restructuring of the highly competitive coal industry resulting in a further decline in numbers of independent coal operators.

DRG/#0330A

STATEMENT OF ROBERT A. HESS

PRESIDENT

NATIONAL ASSOCIATION OF FEDERAL CREDIT UNIONS

BEFORE

THE COMMITTEE ON FINANCE

UNITED STATES SENATE

ON

PROPOSALS TO REPEAL THE TAX EXEMPTION OF CREDIT UNIONS

SEPTEMBER 26, 1985

TABLE OF CONTENTS

	Page No.
Introduction	1
Evolution of Credit Unions' Tax-Exempt Status	2
Provisions of Current Tax-Simplification Proposals	4
The President's Proposal	5
Point/Counterpoint on the Credit Union Taxation Issue	6
Credit Union Size	7
Volunteer Efforts	9
Credit Unions in the Forefront of Insured Institutions	11
Effects of Taxation	12
Safety and Soundness	13
Whither the Gain?	16
Summary	17
Appendix A	19
Appendix B	20
Appendix C	21

Mr. Chairman and members of the Committee, I am Robert A. Hess, President of the National Association of Federal Credit Unions and General Manager of the Wright Patman Congressional Federal Credit Union. The credit union community appreciates this opportunity to participate in the current debate on tax reform. We have examined the impact of various tax-reform proposals on our nation's only member-owned, volunteer-led and consumer-oriented financial cooperatives -- credit unions -- and welcome this opportunity to share our findings with you.

Credit unions play an important role in the financial lives of more than 52 million Americans: members of the armed forces, senior citizens and inner city and rural residents -- taxpaying Americans from all walks of life who have a need for the convenient and low-cost financial services that only credit unions provide. In many cases, these individuals would be deprived of a small savings or share draft account, or they might have no source of credit at all if credit union services were not available to them.

By virtue of an act of Congress, credit unions are tax-exempt. That exemption has existed since the earliest days of the credit union movement. The Congress has reaffirmed that exemption on two occasions. Significantly, during the 98th Congress both the House and the Senate voted overwhelmingly to approve a resolution affirming that credit unions throughout the land remain true to their original aims of providing credit and savings options for consumers of average means. This Joint Resolution was signed into law by President Reagan on August 11, 1983, as Public Law 98-71. (See Appendix A). In accordance with the terms of the resolution, President Reagan issued a Presidential Proclamation on June 18, 1984, reaffirming the distinct contribution credit unions have historically made to our nation's financial health. (See Appendix B). Our comments, today, will examine the rationale of the tax exemption for credit unions, summarize the tax-reform proposals as they might affect that exemption and highlight some of the characteristics that make credit unions unique among all financial organizations. This uniqueness in its many aspects is at the core of the credit union community's argument that the tax exemption for credit unions should not be repealed.

Evolution of Credit Unions' Tax-Exempt Status

Since the 1860s, tax laws at the federal level have almost uniformly recognized that cooperatives and other non-profit institutions should be treated differently from profit-making entities. The law makes this distinction by taxing the distributions of non-profits primarily at the membership level -- *de facto* recognition that the institutions are merely extensions of their members. This distinction has been ever-apparent in the case of credit unions, since they have always operated on a non-profit basis, and since they have statutory membership and service restrictions that limit their competitive stance with other financial organizations. Briefly, Mr. Chairman: Credit unions are true member-owned cooperatives, organized to promote thrift and to create a source of credit for a defined group of individuals who are linked by a common bond. This true-mutuality concept distinguishes credit unions from commercial banks and savings and loans. It means that only the member/owner of the credit union may save and borrow there.

Mr. Chairman, as I mentioned, the tax exemption of credit unions reaches back to the very beginnings of credit unions in the small towns of New England in the early 1900s. The Attorney General of the United States, in 1917, recognized the basic cooperative underpinnings of credit unions in a formal opinion which declared that credit unions were exempt from federal income taxes. Early 20th-century entrepreneurs, such as Edward Filene, saw that credit unions were beneficial in helping workers achieve their personal financial goals. Filene and others not only helped organize credit unions for their employees, but they continued to work hard for their success once they were established.

Efforts to establish credit unions nationwide under the auspices of the Federal government came to fruition in 1934 with the signing of the Federal Credit Union Act by President Roosevelt. This event paved the way for a nationwide system of federally regulated credit unions that have opened the door of financial opportunities for countless millions of working Americans in the intervening fifty years. Following passage of the Federal Credit Union Act, a few states attempted to tax credit unions on the same basis as commercial banks. However, it was evident that such a tax burden would be counterproductive, and Congress intervened in 1937 and granted a full federal income tax exemption for Federal credit unions. In 1951, when Congress ordered the taxation of thrift institutions it left the exemption for credit unions intact because of their true-mutuality concepts. That exemption remains the law today.

The justification for the exemption of credit unions from federal income tax conferred by that 1937 amendment is especially important in the context of today's proposals to tax credit unions. By that single act, Congress made an implicit statement about credit union growth and orientation. It recognized that credit unions have no stockholders and, therefore, no outside source of capital. The exemption has enabled credit unions to maintain their enviable level of reserves while at the same time permitting them to provide low-cost financial services to their members who otherwise might be unable to obtain financial services at anything other than usurious rates.

Provisions of Current Tax-Simplification Proposals

For only the second time in the fifty-one-year history of the Federal Credit Union Act, the traditional tax-exempt status of credit unions is threatened. Significantly, S. 1006/H.R. 2222, the major tax reform proposal introduced by Senator Bob Kasten (R-WI) and Congressman Jack Kemp (R-NY), would retain the tax exemption for credit unions because the sponsors feel strongly that credit unions are unique financial institutions whose non-profit cooperative status justifies their current tax treatment. The credit union community has received written reaffirmation of support for the preservation of the credit union tax exemption from Senator Kasten and Congressman Kemp as well as from many other members of both the Senate and House. I would like to take this opportunity to publicly thank those members who have conveyed their support of the credit union community.

Proponents of repeal of the credit union tax exemption generally base their arguments on the issue of equity: the need to treat financial institutions alike for tax purposes so that one group does not enjoy either an economic or competitive advantage over another. This argument fails to consider that other financial organizations, such as banks and savings and loans, operate in the open marketplace to the benefit of their stockholders. By contrast, credit unions serve only their own fields of membership and function for the sole benefit of their members. There is no separate class of owners in a credit union -- the members own all of the credit union's assets -- and there is, therefore, no profit motive. Members pay federal taxes on their wages when earned and on their credit union dividends -- as is the case with participants in other cooperatives.

The President's Proposal

The President's tax-reform proposal is the focus of most of the dialogue on tax legislation in this Committee and in the Congress. The President's plan is also the focus of most of the concern within the credit union community over the taxation issue. It would tax credit unions with assets of $5 million or more. The proposal would tax over 80 percent of all credit union retained earnings, including statutory reserves.

The Administration paints the virtue of dividing the credit union community by instituting this $5 million threshold as relieving "a significant administrative burden" for the nation's smaller credit unions. We disagree fundamentally. By establishing a system that would exempt only such small credit unions from taxation, a strong disincentive for these small cooperatives to provide necessary services to their members would be built into the tax code. This is because of a fatal flaw in the President's proposal that would subject the credit union's entire income to taxation once the $5 million line was crossed. Similarly, larger credit unions would, in effect, be penalized for their efforts to expand and provide necessary services for the benefit of their members.

Mr. Chairman, credit unions oppose a tax on their reserves and undivided earnings for another basic reason: It is clearly unsound public policy. If the credit union tax exemption is repealed, the unique volunteer features of credit unions will be seriously threatened if not immediately altered, their safety and soundness will be jeopardized and their role as providers of sound financial alternatives to the "for-profit" banking system will be seriously impaired. With your permission, I will, in a few moments, expand on all of these points, Mr. Chairman. But first, I believe it is important to deal with some of the arguments that are somewhat carelessly bandied about by proponents of taxing credit unions.

Point/Counterpoint on the Credit Union Taxation Issue

First, there is the so-called "level-playing-field" argument -- the assertion that credit unions hold a competitive edge in the financial marketplace over banks and savings and loans. Credit unions flatly reject this erroneous assertion, and we have the irrefutable facts to buttress our position.

If it were true that credit unions hold a competitive advantage over other financial institutions that are taxed, then, by extension, these member-owned financial cooperatives, which outnumber banks and thrifts combined, would hold most of the consumer credit and deposits across the board. In fact, in 1984, credit unions held only 14.9 percent of installment credit in the country and were the recipients of only 5.2 percent of savings deposits. While credit unions have been successful for the most part, they have gained that status from providing basic financial services to the average worker at the lowest possible cost and at places that are convenient for the member. In truth, credit unions, with volunteer boards of directors and committees, offer a good return on savings and they make low-cost loans to a defined field of membership because they were established expressly to give the average consumer the benefit of their lower costs of operation. This is not an unfair competitive edge, Mr. Chairman; it's the result of good management and the "people-helping-people" philosophy at its best -- the same fundamental service principles that President Reagan so strongly supports.

Credit Union Size

Another allegation made by proponents of taxing credit unions is that they have grown disproportionately from other classes of financial institutions. To this assertion we say: "Nonsense!" Mr. Chairman, none less than the General Accounting Office, in analyzing the proposal to tax credit unions, noted that 99.5 percent of Federal credit unions had assets of less than $100 million in 1983. Citing the growth in the deposit bases of both banks and savings and loans, the GAO concluded that, "...overall, credit unions are not a serious competitive threat to...[their] taxed competitors." (See Appendix C). Another glimpse within this area is also illuminating: the market share of consumer loan activity for credit unions as a whole has actually declined by over two percentage points in recent years.

Despite what the recent GAO report said about the relative size of credit unions, some who do not understand the function of credit unions hold that the larger credit unions are substantially equivalent to commercial banks and thrifts. This assertion is also untrue. The size of a credit union is dependent on the size of its field of membership. That base is influenced by a number of factors that wholly transcend market forces. For example, if a company decides to consolidate several field installations at a single location, the credit unions serving the various installations could be consolidated as well. While the credit union might have "grown" in discrete terms, the same number of members are being served. Furthermore, some of our nation's larger credit unions have grown over the years because of their willingness to respond to the requests of government officials that they provide services to specific groups of people who would otherwise be without financial services.

A clear example of the benign factors that propel credit union growth is shown in the following example. Navy Federal Credit Union is the nation's largest, with almost 700,000 members, worldwide, and over $1.6 billion in assets. I can assert, categorically, Mr. Chairman, that the Department of the Navy, itself, has been one of the prime catalysts in this growth. At the request of the Secretary of the Navy, the Navy Federal Credit Union has established facilities on bases and at other locations formerly served by other financial organizations. Those locations were abandoned because they were unprofitable, for the most part. Credit unions, such as Navy Federal, willingly serve the servicemen and servicewomen at remote locations because they want to provide financial assistance at the lowest possible cost. For its part, the Department of the Navy has a firm policy of assisting credit unions "at all echelons..." and encourages its personnel to volunteer their services as unpaid credit union officials -- in contrast to the many restrictions it places on their involvement in commercial enterprises. Across the country, employer after employer espouses the same philosophy. For example, it is quite routine for a credit union sponsor (employer) to provide space for the operations of the credit union. Many also provide payroll options -- such as direct deposit -- that foster regular savings at the credit union.

Volunteer Efforts

Mr. Chairman, I turn now to some of the characteristics that have helped spur the growth of credit unions and of which we in the credit union community are justifiably proud. Perhaps one of the most unique features of the movement is the substantial volunteer effort at both the board-of-directors level and at the operating level -- a feature not found in other financial organizations. This spirit of volunteerism and the strong community orientation of credit unions go hand in hand. By law, board members, except for a single member, serve without compensation. At the present time there are over 250,000 volunteers in the credit union movement. In fact, at least one-third of the approximately 18,500 credit unions in the nation have no full-time employees. They carry out their financial services with volunteers for the most part.

At first glance, one might say that taxing credit unions would not disrupt this historical community connection in the credit union movement; but, as a result of taxation, we foresee pressures developing to compensate directors and other volunteers. In that eventuality, an important, albeit intangible, quality in the credit union community would be lost. Moreover, many credit unions would be devastated financially if they were required to compensate their volunteer officers and support personnel. Across the credit union spectrum, these volunteer services are estimated to be worth some $200 million in this calendar year.

I believe it is readily apparent that if these pressures developed following taxation, the historical community connection of credit unions -- people helping people -- would change radically. Not only would employers and other sponsors feel differently about profit-making, taxpaying organizations, but the bedrock of credit union management -- the volunteer directors -- would be under great pressure to change the operating philosophy of credit unions. For example, tax-planning would require the services of professionals who would insist on being compensated for their expertise. The profit motive would inevitably surface, and credit union boards of directors would be selected with this view, as opposed to the non-profit orientation of present-day directors and officers.

Credit Unions in the Forefront of Insured Institutions

Another clear distinction between credit unions and other providers of financial services is found in the manner in which credit unions insure their members' accounts. As a result of actions initiated in Congress last year, provisions which we supported and which were added to the Deficit Reduction Act of 1984, on January 21, 1985, all federally-insured credit unions placed an amount equal to one-percent of their insured shares in the National Credit Union Share Insurance Fund (NCUSIF).

While the intended result of creating a strong insurance fund for credit unions was achieved (in fact, the NCUSIF is now the strongest of the three federal deposit insurance funds), a little noticed benefit to the country as a whole was also realized. By capitalizing the NCUSIF in the manner which the credit union community sought and the Congress prescribed, our country's credit unions reduced the federal deficit by almost $800 million on January 21 of this year when they placed their deposits in the fund. Thus, credit unions contributed 8 percent of the deficit reduction achieved in 1985 as a result of the Deficit Reduction Act. Credit unions' contribution to deficit reduction will continue, year after year, as credit unions increase their NCUSIF deposit to reflect growth. It is very likely that, left untaxed, credit unions will make a $120 million contribution to the reduction of the deficit next January. An even larger contribution can be anticipated in future years. And I stress: that act of deficit reduction on the part of credit unions will take place without legislating any change in our tax status. If credit unions are not saddled with an anti-growth tax, their contribution to deficit reduction is expected to total $9.2 billion by the turn of the century.

Effects of Taxation

In addition to these considerations, Mr. Chairman, there are several troublesome scenarios that would likely follow taxation of credit unions. For example, many credit unions might consciously look for ways to reduce their taxable income or to maximize profits through resort to speculative investments. The President's proposal, in its analysis of the recommendation to tax credit unions with assets of $5 million and over, states that "...large credit unions would have to increase the spread between their 'dividend' rates and loan rates...." However, was any consideration given to the effects of such a policy on the safety and soundness of credit unions and their members? Harking back to an earlier point, Mr. Chairman: If taxed, credit unions would be forced into direct competition with banks and thrifts. Yet, credit unions, in terms of aggregate deposits, are less than 1/20th the size of banks and about 1/10th as large as thrifts.

Eventually, credit unions would lose their indentity and would, of necessity, become like banks and savings and loans. Even in this case, only the strongest and fittest credit unions would be able to compete with the other classes of financial institutions. Mr. Chairman, this is a particularly ironic scenario. At a time when the chairman of one of the largest financial networks in the country calls for the establishment of "family banks" to better serve the needs of consumers, credit unions are being earmarked for changes that would erode forever their strong commitment to providing low-cost financial services to consumers of average means.

These prospects are particularly frustrating given the quality of service that credit unions now provide to their members. This was graphically revealed in a 1984 survey conducted by the American Banker. The survey showed that seventy-one percent of credit union respondents are very satisfied with credit union service. The same poll showed that customers of banks and savings and loans are less than half as well satisfied with their respective institutions. Yet, despite the relationship that credit unions have nurtured with their members, their ability to continue to provide these services would be severely impaired if taxation is imposed.

Safety and Soundness

Another major concern of the credit union movement over taxation is the effect on safety and soundness -- two fundamental elements central to the stability of any financial system. Unlike stock-issuing financial institutions, the ownership of credit unions is reflected in members' holdings of shares (savings) in the credit union. Therefore, there is no source of capital other than retained earnings to provide for contingencies. These reserves in the credit union serve several needs, Mr. Chairman: (1) they are the source of funds for assuring that the credit union meets the statutory requirements for reserves sufficient to cover loan losses and non-productive investments; (2) they allow credit unions to keep pace with the rapidly changing technological requirements of the financial services industry; and (3) they provide the reserves needed to keep credit unions on par with the needs of their members.

The effects of taxation on credit unions' reserves would differ under each of the bills now before the Congress proposing the taxation of credit unions; however, if the President's proposal had been in effect for the tax years 1975-84, we estimate that credit unions' reserves would have been reduced by over 25 percent. This is a "best-case" scenario in that it assumes that credit unions would grow at the same rates under taxation; in reality, we believe that taxation would stifle credit union growth and force untold numbers of them out of business. Mr. Chairman, credit unions simply cannot survive without strong reserve underpinnings.

Because of this palpable link between credit unions' level of reserves and their safety and soundness, we in the credit union community are nonplussed that the President's proposal goes to some length to note that "[i]n 1983, Federal credit unions...retained earnings...were 10.6 percent of current net earnings." This seemingly benign statement implies that such a transfer to retained earnings was a ploy on the part of credit union managers to do something unwarranted or devious. Yet, the Federal Credit Union Act itself requires that 10 percent of operating income be placed in reserves until prescribed percentage levels of outstanding loans and risk assets are reached. To place this in perspective, on February 24 of last year, the chief federal regulator of credit unions wrote to the then-Chairman of the Senate Finance Committee in a cautionary vein:

> "While I am, of course, always concerned with contributing in any way to deficit reduction, my primary interest in this matter is safety and soundness. In my judgment, the taxation of credit unions could seriously affect their financial soundness. In an effort to minimize any taxation, credit unions would concentrate on returning as much of their earnings as possible to their members in the form of dividends. However in doing so, many could inadvertently jeopardize their financial picture, including their reserve base..."

Moreover, a study performed by a certified public accountant very knowledgeable in the area of credit union operations shows that perhaps as few as one-third of all Federal credit unions could maintain their statutory reserve levels, even in the initial period, if the President's tax proposal were to be enacted. As is painfully evident from the recent spate of bank and thrift failures, under-capitalization of any financial institution is the root cause of insolvency.

It is no accident that credit unions have their enviable safety record, Mr. Chairman. In 1970, they banded together to start their own share insurance program; and they did this with no seed capital from the federal Treasury -- a departure from the earlier FDIC and FSLIC programs in which the government supplied the start-up funds.

Building on this initiative, credit unions developed a philosophy of taking care of their own problems. This has been achieved through strong reserve positions, enlightened management of the share insurance program and, perhaps most important, their firm commitment to self-help principles and to the economic well-being of their members.

Whither the Gain?

Mr. Chairman, one of the most bothersome elements to the credit union community during this tax debate is the fact that the Administration and others are willing to cast the pall of uncertainty over credit unions for so little revenue gain when measured against the inevitable hardships and dangers. Clearly, credit union members across the spectrum would suffer economically. Preliminary estimates by many of our credit unions on the effects of the President's tax proposal show that loan rates might have to be raised or share dividend rates reduced by a spread of as much as two percentage points. Moreover, service fees would have to be imposed on non-fee services and existing fees increased. One or more of these measures would follow swiftly if the President's or other proposals to tax credit unions were enacted; and all of them might have to be put in place beyond the first year of taxation. In effect, the plans to tax credit unions place a new financial burden on the wage earners who use credit unions as their sole source of financial services.

And what would all of this generate? By Administration estimates, not more than $200 million in FY 1986. By our own calculations, considering tax-avoidance strategies that virtually all credit unions could employ, coupled with the throttling of credit union growth, the actual gain in revenues by taxing Federal credit unions would be less than $100 million in each of the initial three years.

Summary

In conclusion, Mr. Chairman, we believe that credit unions' place in the structure of the financial services industry would be adversely affected if the current proposals in the Congress to tax credit unions were enacted. Their special niche as providers of low-cost financial services to individuals of modest means would be placed in jeopardy; indeed, we envision that many credit unions would not be able to pay a sufficient return on savings to enable them to effectively meet their statutory mandate to promote thrift. Consider also the fact that credit unions presently have statutory restrictions that distinguish them from other financial institutions. They do not serve the public at large, because only individuals within their fields of membership may join the credit union, nor can they make loans for commercial endeavors. These limitations and restrictions place credit unions in a far different position than banks and thrifts as providers of financial services. Credit unions are true mutual organizations; they are owned by their members, each of whom has the same voice in the management of the credit union -- regardless of the number of shares held. An oft-overlooked fact is that credit unions have no incentive to make large profits that escape taxation. Their net income is paid to members as taxable dividends; paid into reserves, by law, to assure the safety of members' deposits; or retained in small amounts for growth and for member services.

Thus, there is no "tax" rationale for the taxation of credit unions. Proponents of taxation, if they have their way, would make credit unions into wholly different, profit-making entities -- devoid of the member service and consumer orientation that have helped millions of citizens of average means to achieve their part of the American dream. In speaking out on taxation, credit unions ask only that those in the Congress and the Administration who are proposing to tax credit unions look at all the facts. After such a review, we are convinced that impartial lawmakers will conclude that taxing credit unions will do irreparable harm and could reverse decades of progress in the evolution of a financial system that serves as a valuable alternative to the "for-profit" banking system.

That concludes my remarks, Mr. Chairman. I will be glad to respond to any questions that you or other members of the Committee may have.

oOo

Public Law 98-71
98th Congress

Joint Resolution

Aug. 11, 1983
[H.J. Res. 139]

To designate the week beginning June 24, 1984, as "Federal Credit Union Week".

Whereas on June 26, 1934, President Franklin Roosevelt signed into law the Federal Credit Union Act;

Whereas the enactment of the Federal Credit Union Act enabled credit unions to be organized throughout the United States under charters approved by the Federal Government;

Whereas Federal credit unions are cooperative associations organized in accordance with the provisions of the Federal Credit Union Act for the purpose of promoting thrift among their members and creating a source of credit for provident or productive purposes;

Whereas Federal credit unions have consistently reflected the cooperative spirit of people helping people and the philosophical tradition that gave birth to the Federal Credit Union Act; and

Whereas June 26, 1984, is the fiftieth anniversary of the date of the enactment of the Federal Credit Union Act: Now, therefore, be it

Federal Credit Union Week.

Resolved by the Senate and House of Representatives of the United States of America in Congress assembled, That the week beginning June 24, 1984, hereby is designated "Federal Credit Union Week", and the President of the United States is authorized and requested to issue a proclamation calling upon the people of the United States to observe such week with appropriate ceremonies and activities.

Approved August 11, 1983.

LEGISLATIVE HISTORY—H.J. Res. 139:

CONGRESSIONAL RECORD, Vol. 129 (1983):
July 25, considered and passed House.
July 27, considered and passed Senate.

○

11-139 O - 83 (71)

Presidential Documents

Appendix B

Proclamation 5211 of June 18, 1984

Federal Credit Union Week, 1984

By the President of the United States of America

A Proclamation

This year marks the fiftieth anniversary of the passage of the Federal Credit Union Act of 1934 which enabled credit unions to be organized throughout the United States under charters approved by the Federal government.

Credit unions are uniquely democratic economic organizations, founded on the principle that persons of good character and modest means, joining together in cooperative spirit and action, can promote thrift, create a source of credit for productive purposes, and build a better standard of living for themselves. Because credit unions exemplify the traditional American values of thrift, self-help and voluntarism, they have carved a special place for themselves among the Nation's financial institutions.

Today, Federal credit unions are at their strongest point in history. They enter this, their 50th anniversary year, as the Nation's fastest-growing financial institutions. As member-owned cooperatives, credit unions operate with the credo, "Not for profit, not for charity—but for service." Credit unions have maintained allegiance to this ideal and as a result have consistently reflected the philosophical tradition and the cooperative spirit of people helping people that prompted passage of the Federal Credit Union Act.

The Congress, by House Joint Resolution 139, has designated the week beginning June 24, 1984 as "Federal Credit Union Week" and has authorized and requested the President to issue a proclamation calling for the observance of this occasion.

NOW, THEREFORE, I, RONALD REAGAN, President of the United States of America, do hereby proclaim the week beginning June 24, 1984, as Federal Credit Union Week. I call upon the people of the United States to celebrate this week with appropriate ceremonies and activities.

IN WITNESS WHEREOF, I have hereunto set my hand this eighteenth day of June, in the year of our Lord nineteen hundred and eighty-four, and of the Independence of the United States of America the two hundred and eighth.

Ronald Reagan

[FR Doc. 84-[illegible]
Filed 6-19-84; [illegible] pm]
Billing code 3195-01-M

BY THE COMPTROLLER GENERAL

Report To The Chairman, Senate Committee On Governmental Affairs

OF THE UNITED STATES

Compendium Of GAO's Views On The Cost Saving Proposals Of The Grace Commission

Vol. II - Individual Issue Analyses

UNITED STATES GENERAL ACCOUNTING OFFICE

GAO/OCG-85-1
FEBRUARY 19, 1985

BANK 23: TAXING OF CREDIT UNIONS

I. PPSSCC ISSUE AND SAVINGS

Should credit unions be taxed?

The PPSSCC projected potential revenue of $379 million over 3 years.

II. GAO ANALYSIS OF ISSUE AND ASSOCIATED RECOMMENDATIONS

Since this is a complex matter—more complex than the treatment given by the PPSSCC—GAO can take no position on this issue without much further study.

The PPSSCC believes that the tax exemption given to credit unions should be ended because they are beginning to conduct lines-of-business similar to commercial banks and savings and loans, both of which are taxed. The PPSSCC contends that original credit unions were small and their memberships were comprised of persons with close bonds. Now, however, there are some large ones with very broad memberships. Thus, since they are competing with other financial institutions, they should be taxed similarly.

National Credit Union Administration (NCUA) officials disagree with the recommendation. The officials point out that tax exemption is based on the nature of credit unions' organizations: they are not-for-profit cooperatives. Theoretically, all earnings not absorbed by costs of operations are distributed to members as dividends, which are taxable to the individuals. Presuming that only undistributed earnings would be taxed, credit unions, upon losing the exemptions, would simply distribute all earnings to their members.

There are a number of arguments against the recommendation to end the tax exemption. Although credit unions may be growing, as of December 31, 1983, 99.5 percent of all federal credit unions still had assets of less than $100 million, and 68 percent had assets of less than $2 million. By commercial bank standards, those institutions are very small.

Moreover, both federal- and state-chartered credit unions had deposits totaling $75.5 billion, while commercial bank deposits totaled $1.5 trillion, and savings institutions totaled $618 billion. Thus, overall, credit unions are not a serious competitive threat to the taxed competitors. Indeed, GAO is unaware of any major protestations by banks or savings and loans that credit unions enjoy an unfair competitive advantage.

However, a business practice test might conclude that at least some credit unions should be taxed. Some are very large. The 59 federal credit unions with $100 million or more in assets (out of a total of 10,962 federal credit unions) hold about 22 percent of all federal credit union assets. Also, some credit unions are broadening their membership bases. There is tax legislative history pertaining to the mutual savings industry that demonstrates that when some large mutual companies stopped "behaving" like true cooperatives, they were taxed. Presumably, if a body of evidence could show that credit unions have stopped behaving like cooperatives--including complex financial analyses not performed by the PPSSCC--then a case for taxation might be made.

III. GAO ASSESSMENT OF IMPLEMENTATION AUTHORITY, FEASIBILITY, AND STATUS

The PPSSCC concluded that legislative changes would be needed to implement the recommendaton, and GAO agrees. Adopting the recommendation would require a change to federal tax laws (sects. 501(c)(1) and 501(c)(14) of the Tax Code). Such a change is technically feasible, given the changes to the insurance industry tax structure.

IV. GAO ANALYSIS OF SAVINGS ESTIMATE

Since no figures were presented to back the PPSSCC estimate, GAO could not analyze them.

V. RELEVANT GAO REPORTS

GAO/PAD-81-1	Billions of Dollars Are Involved in Taxation of the Life Insurance Industry--Some Corrections in the Law Are Needed (Sept. 17, 1981)

VI. GAO CONTACT

Craig Simmons 275-8678

STATEMENT OF THE
NATIONAL COUNCIL OF COAL LESSORS, INC.
TO THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
ON
PRESIDENT'S TAX PROPOSALS TO THE CONGRESS
FOR FAIRNESS, GROWTH AND SIMPLICITY
September 26, 1985

Mr. Chairman, Members of the Committee:

I am James Davis, President of the National Council of Coal Lessors, Inc. We appreciate this opportunity to comment on the President's Tax Proposals.

The National Council of Coal Lessors is an association whose members include coal land owners of all sizes from most of the important coal producing regions in the country -- from small coal land owners to large corporate coal lessors. I believe that virtually all of the members of the association would be adversely affected by the Administration's tax proposals.

Under existing provisions of the Internal Revenue Code, coal royalties received by lessors of coal lands, subject to certain limitations, are taxed at capital gain rates. To qualify the lessor must retain an economic interest in the reserves transferred and must have held the property for more than six months at the date the coal is mined. Capital gain treatment does not apply to any disposal of coal to a related person or to a person owned or controlled directly or indirectly by the same interests which own or control the person disposing of such coal. Percentage depletion is not allowed on royalties qualifying for capital gains treatment.

Under the Administration's tax proposals, capital gain treatment of coal royalties would be phased out over a three-year period and coal royalties would be taxed as ordinary income. Taxation of such royalties as ordinary income cannot be justified, would be highly inequitable and contrary to sound public policy.

An outright sale of a coal property is subject to capital gain treatment. If an owner sells a tract of coal land for $500 an acre, the gain, if any, under existing law and under the Administration's tax proposals, is taxed at capital gain rates for Federal income tax purposes if the owner has had the requisite holding period.

The basic difference between an outright sale of a coal property and a disposal contract, such as a coal lease, is that in a sale ownership is transferred immediately with payment of the agreed sale price made in a lump sum or in stipulated installments; whereas, in a lease, ownership is transferred and stipulated payments per ton of coal are made as mining takes place.

Historically most tracts of coal lands are not sold outright but are leased to coal mine operators. As a consequence, title to the coal does not normally pass from the owner of the coal to the operator until the coal is actually extracted. The pervasive use of a lease rather than an outright sale is dictated by two primary considerations.

One, neither the owner of the coal nor the coal operator can know with any precision the quality, quantity and economic value of the coal until the same is actually mined. Accordingly, a conventional coal lease, in order to insure a fair valuation of the coal itself, provides for a tonnage royalty payable by the operator to the lessor following extraction and sale of the coal.

Two, because of the cost intensive nature of the coal mining business, most coal mine operators are unwilling to invest their capital in the coal itself but prefer to lease the coal so that they pay for the coal at the time of extraction and sale.

Thus, even though coal land owners would prefer an outright disposition, practical considerations often prevent them from doing so. Consequently, the only choice often available to a coal land owner is to dispose of his assets on a unit-by-unit basis in the form of royalties via a disposal contract as the coal is mined and sold by the operator.

Realistically, a lease of coal land authorizing the mining of coal in place in consideration for the payment to the mineral owner of a tonnage royalty following extraction and sale of the coal is the functional equivalent of an installment sale by the mineral owner of a nonrenewable asset. When so viewed, the substance and character of the royalty payment is the same as the substance and character of the consideration received by the owner in an outright sale of the coal property.

Accordingly, the income tax consequence with respect to these two types of dispositions of coal in place should be the same. The inherent logic of this analysis was accepted by Congress in 1951 when it enacted legislation according to capital gain treatment to coal royalties. It is our position that this treatment properly recognizes that coal royalties are the functional equivalent of the sale of a capital asset and are not in any sense ordinary income.

One of the stated goals of the Administration's tax proposals to the Congress is fairness. The elimination of the capital gain treatment of coal royalties clearly would be unfair to coal lessors who have acquired coal properties or entered into long term coal leases, or both, on the assumption that coal royalties received over the term of these leases would be taxed at capital gain rates. Many coal lessors have invested substantial sums to acquire coal properties -- often over extended periods of time. Coal lessors would suffer severe and unjust financial hardships if coal royalties are now taxed as ordinary income.

The Administration's tax proposals recognize that capital gain treatment "encourages the flow of capital to new and innovative activities that involve high risk yet offer large economic and social returns." It is important to recognize that capital gain treatment of coal royalties was enacted to and will continue to encourage the development of domestic coal reserves.

Coal is our most abundant energy resource. The encouragement of the development of domestic coal reserves is essential if America's effort to achieve energy independence and to reduce the nation's dependence on imported energy supplies is to be successful. Among the tax incentives that have encouraged the development of domestic coal reserves has been the capital gain treatment accorded property owners who dispose of their reserves by way of long-term lease arrangements. The proper sales classification of coal as a capital asset has unquestionably stimulated the development of coal properties.

The introduction of the Administration's tax proposals states that "special subsidies or preferences for specific industries or sectors should be curtailed except where there is a clear national security interest that argues to the contrary." Coal is a vital natural resource essential to our national security program. With coal representing over 80% of our country's fuel reserves, its development is essential so we are not vulnerable to cutoffs of our oil supplies. The future development of our domestic coal reserves depends upon fair tax treatment which encourages the development of and investment in these reserves.

Government revenue estimates of the cost, on a static basis, of continuing the capital gain treatment for coal royalties show that the tax loss is negligible. The loss is so slight as to be listed as an asterisk in the Administration's revenue estimates. These cost figures ignore the dynamic interaction of the increased tax liability which in the long term will produce less revenue as the cost of leases will be raised to the lessee whenever possible, thereby further reducing the profit of the lessee.

If capital gain treatment for coal royalties is repealed, coal land owners will seek higher royalty rates when new leases are negotiated or old leases renegotiated to compensate for the increased tax liability. The elimination of capital gain treatement for coal royalties is only one of a number of the Administration's tax proposals which would adversely impact an already depressed coal industry. The phase-out of percentage depletion allowances, excess depreciation recapture, repeal of the investment tax credit, loss of accrual of reclamation reserves and the inclusion of certain mining incentives as preference items under the proposed alternative minimum tax will also affect an already depressed industry.

The net effect of the Administration's tax proposals on the coal industry will result in a higher level of tax liability which eventually will result in a price increase or a lower level of profitability or both. The Energy Information Administration of the Department of Energy in a recent Service Report forecasts a coal price increase of 4.7 percent over the next five years as a result of the proposed tax changes. The possible effects of an increase in the price of coal include the following:

1. Electric utility bills will rise.
2. Coal exports will fall due to higher priced coal.
3. The balance of payments will worsen.
4. Coal production will fall.
5. Tax receipts from coal royalties will fall because less coal will be sold.
6. Unemployment will increase.

In summary, a lease of coal lands authorizing the mining of coal in place in consideration for the payment to the mineral owner of a tonnage royalty following extraction, is the functional equivalent of an installment sale by the mineral owner of a non-renewable asset. Thus, the Congress has properly classified disposal contracts of coal in place with a retained economic interest as sales. Fairness dictates the continuation of the capital gain treatment of coal royalties. Government revenue estimates of the cost of continuing the capital gain treatment of coal royalties show that the tax loss is negligible. Sound public policy mandates a tax policy that encourages the proper development and management of our coal resources. Therefore, we recommend that the existing capital gains treatment of coal royalties be retained. Coal royalties should be taxed as capital gains not as ordinary income.

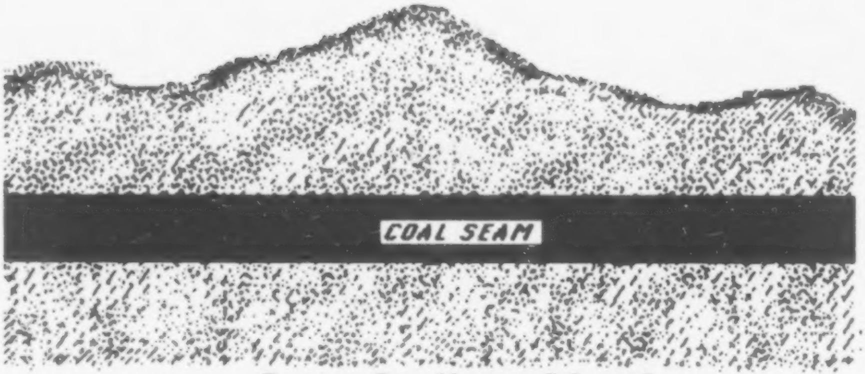
Summary Statement of

National Council of Coal Lessors, Inc.

1. Under existing provisions of the Internal Revenue Code, coal royalties received by lessors of coal lands, subject to certain limitations, are taxed at capital gain rates.
2. A lease of coal land authorizing the mining of coal in place in consideration for the payment to the mineral owner of a tonnage royalty following extraction and sale of the coal is the functional equivalent of an installment sale by the mineral owner of a nonrenewable asset.
3. An outright sale of coal property is subject to capital gain treatment.
4. Accordingly, the income tax consequence with respect to these two types of dispositions of coal in place should be the same.
5. Thus, Congress has properly classified disposal contracts of coal in place with a retained economic interest as sales.
6. Fairness dictates the continuation of the capital gain treatment of coal royalties.
7. Government revenue estimates of the cost of continuing the capital gain treatment of coal royalties show that the tax loss is negligible.
8. Sound public policy mandates a tax policy that encourages the proper development and management of our coal resources.

EXHIBIT "C"

Illustration of the Present Method of taxing profits from sale of Coal in Place



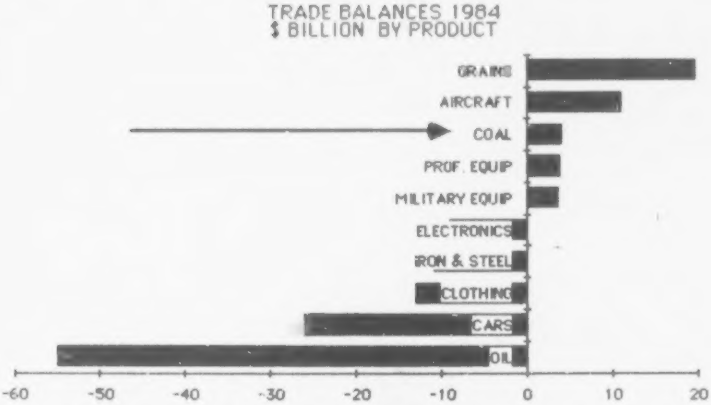
Cross Section of Land

COAL DEED -	Sale price paid by purchaser in lump sum or installments. Profit is properly taxed as capital gain.
COAL LEASE-	Sale price paid by purchaser per ton of coal mined. Profit is properly taxed as capital gain.

Since coal leases are sales of undeveloped real estate held for long term investment, the same as coal deeds, any profit from sale by coal leases should be treated as capital gain as the profits from sales by coal deeds are treated.

EXHIBIT "D"

COAL CONTRIBUTES OVER $4 BILLION TO THE BALANCE OF TRADE



SOURCE: U.S. DEPARTMENT OF COMMERCE INTERNATIONAL TRADE ADMINISTRATION & THE ECONOMIST

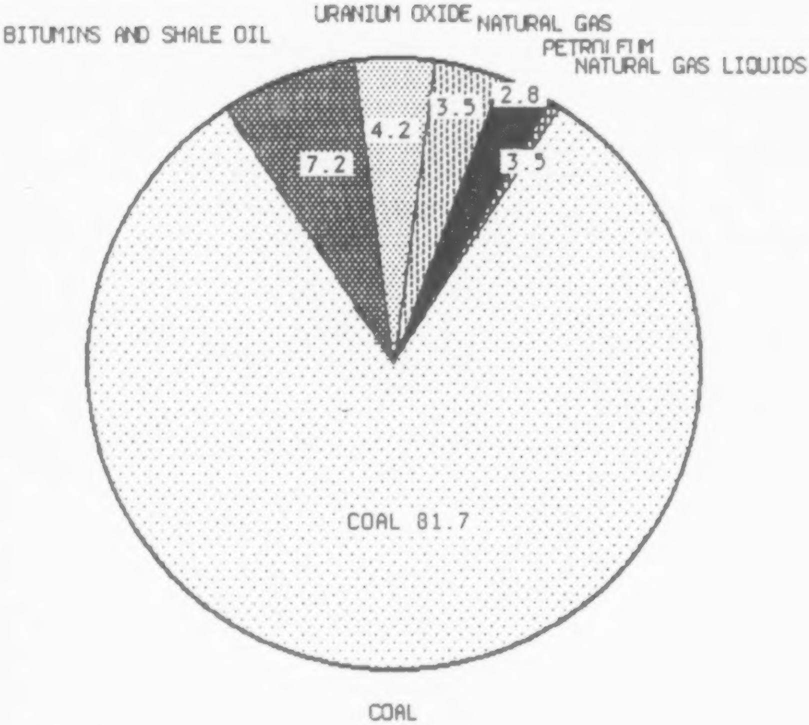
ELIMINATING THE CAPITAL GAINS TAXATION OF COAL ROYALTIES WILL ULTIMATELY BE REFLECTED IN HIGHER PRICES MAKING COAL LESS COMPETITIVE IN WORLD MARKETS AND OPENING THE DOOR TO FOREIGN IMPORTS.

EXHIBIT "A"

COAL IS AMERICA'S ACE IN THE HOLE

KNOWN RECOVERABLE U. S. ENERGY RESERVES

COAL MAKES UP OVER 80% OF AMERICA'S RESERVES



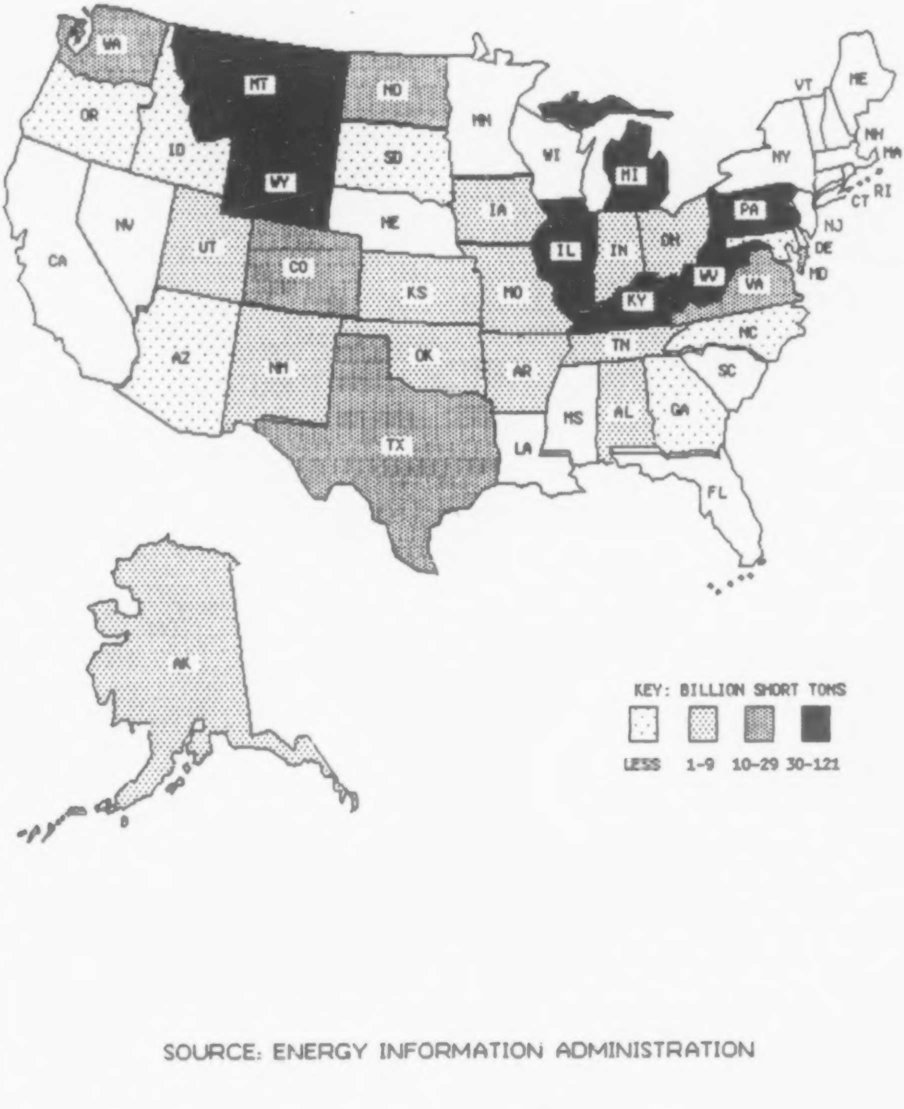
PERCENT ACCORDING TO BTU CONTENT

SOURCE: BUREAU OF MINES

EXHIBIT "B"

U S DEMONSTRATED COAL RESERVE BASE

(BILLION SHORT TONS)


WA
OR
ID
MT
ND
MN
SD
WY
WI
MI
NY
VT
ME
NH
MA
RI
CT
NV
CA
UT
CO
NE
IA
IL
IN
OH
PA
NJ
DE
MD
WV
VA
KY
KS
MO
AZ
NM
OK
AR
TN
NC
SC
TX
MS
AL
GA
LA
FL
AK
KEY: BILLION SHORT TONS
LESS
1-9
10-29
30-121

SOURCE: ENERGY INFORMATION ADMINISTRATION

STATEMENT OF
THE NATIONAL COUNCIL OF SAVINGS INSTITUTIONS

COMMITTEE ON FINANCE
UNITED STATES SENATE

THE IMPACT OF THE PRESIDENT'S TAX SIMPLIFICATION PLAN ON THE FINANCIAL SERVICES INDUSTRY

SEPTEMBER 26, 1985

The National Council of Savings Institutions appreciates the opportunity to comment on the President's Tax Simplification Plan and its effect on our member institutions.

The National Council was formed a year and a half ago through the consolidation of the National Association of Mutual Savings Banks and the National Savings and Loan League. The Council represents approximately 600 savings institutions with more than $400 billion in assets, with operations or investments in all fifty states.

The economic climate of the 1980's has created substantial changes for the members of the National Council and the thrift industry in general. The unprecedented high market interest rates in 1981 and 1982 coupled with the imbalance in the structure of thrift institution's long-term mortgage assets and short-term liabilities led to widespread losses in the industry. As prevailing interest rates declined in 1983 and 1984 and the assets and liabilities of thrifts were deregulated, the industry as a whole has become profitable. Nevertheless, these earnings problems materially affected the regulatory environment and the structure of the industry.

The large losses incurred in the early 1980's depleted the capital of thrift institutions. In many cases, the capital base of institutions built over a period of 50 years was exhausted during a two year period. Consequently, many firms failed or were merged out of existence. Legal and regulatory changes implemented to forestall an adverse impact on future earnings have yielded mixed results to date. The rebuilding of capital through the restructuring of assets and liabilities by the thrifts is still in the early stages.

While we at the Council believe that tax reform is desirable and applaud the efforts of the Administration, we have some important concerns that should be addressed before we endorse specific tax reforms.

o The corporate rate should be no higher than the 33 percent contained in the President's Proposal. Under present law the effective tax rate for thrifts is approximately 31 percent. The repeal of the special bad debt deduction will increase the effective tax rate, which must be offset by a lower statutory rate to foster recapitalization of the industry.

o Changes in the bad debt deduction should not include the application of a retroactive recapture of existing reserves. The proposed recapture of existing reserves would immediately eliminate a substantial portion of the existing net worth of the industry.

o Congress should adopt some reasonable method of computing bad debt deductions for all corporations, including thrifts, to provide conformity with accounting and regulatory reporting practices.

o Net operating loss carryforwards should be available to thrift institutions on the same basis as to other corporations. Failure to allow the carryforward of existing losses created by high interest rates would unnecessarily impair the recapitalization of the industry where other corporations have been given such treatment.

o The reorganization rules for thrift institutions should be changed to provide similar treatment for FDIC insured thrifts as for FSLIC and state insured thrifts. The failure to apply comparable rules puts FDIC insured thrifts on an unlevel playing field with FSLIC and state institutions.

o Cash basis accounting should continue to be available to thrift institutions. Requiring thrifts to compute income on the accrual basis while their customers compute income on the cash basis creates an unnecessary mismatching or revenue to thrifts in relation to recognition by individuals.

TREASURY PLAN PROVISIONS RELATING TO SAVINGS INSTITUTIONS

REPEAL OF BAD DEBT DEDUCTION

A. SPECIAL BAD DEBT DEDUCTION

During the 1960's, Congress provided thrift institutions with special taxation rules designed to encourage home mortgage lending and compensate thrift institutions for limited investment capabilities. Until 1969, the special bad debt deduction was calculated as 60 percent of taxable income and was not subject to preference tax. In 1969, Congress enacted legislation to reduce this special percentage bad debt deduction from 60 percent to 40 percent on a scheduled basis. In exchange for the reduction of the special bad debt deduction, thrifts were provided the ability to carryback net operating losses ten years with a five-year carryforward. Later tax legislation further reduced the benefit of the percentage bad debt deduction through inclusion of this deduction as a preference item.

Thrift institutions should be able to adjust to the repeal of the special bad debt deduction if corporate rates are dropped to at least the suggested 33 percent level. With continued cutbacks in special bad debt deductions (through preference limitations, the minimum tax, and other restrictions), our profitable members currently pay tax at an average rate of 31%, and then only if they qualify for the special bad debt deduction.

In the event that the maximum corporate tax rate is established at 33 percent, then the elimination of the special bad debt deduction would have less impact. In the event, however, that the maximum effective corporate tax rate is established at some higher rate, then to provide for an equitable transition rule, the reduction of the existing special percentage bad debt deduction over a specified number of years would be preferable to immediate elimination. This would allow thrifts to adjust to higher effective rates over time. This approach was taken when the special bad debt deduction was reduced by the 1969 tax act.

Restrictions in other deductions and credits (the 50% limit on the investment tax credit for financial institutions, the restrictions on the dividends received deduction, and increased charitable contributions limitations) should be eliminated if the section 593 reserve deduction is repealed.

B. GENERAL CORPORATE BAD DEBT DEDUCTION

While we can accept the elimination of the special bad debt deduction, we do not concur with the elimination of some acceptable formula for calculating a bad debt reserve applicable to all corporations. The President's proposal to adopt the direct write-off method is contrary to proper accounting logic and will result in tax losses being recognized in periods which differ substantially from provisions recorded in audited financial statements. For many years, financial institutions have been required to record loan loss provisions, based upon estimated loan losses, to properly match revenues and expenses of each fiscal year. The requirement to adopt the direct write-off method would result in taxation of some revenue that is never collected. We believe that bad debt expense for tax purposes based upon the greater of the allowable percentage bad debt deduction or the amounts estimated for audited financial statements would provide for an appropriate transitional rule.

This problem would not exist if Congress accepted the basic tax premise of book income reporting, which requires that a reasonable addition be added to reserves for anticipated losses. This is especially critical for financial institutions, which must maintain such reserves for regulatory purposes.

RECAPTURE OF BAD DEBT RESERVES

In conjunction with the repeal of the special bad debt reserve method, the Proposal would require thrift institutions to recapture a portion of their existing tax reserves. The purpose is twofold:

1. To prevent a double deduction for debts that become wholly or

partially worthless after the effective date of the repeal of the bad debt deduction reserve method.

2. To put thrift institutions on an equal footing with other corporations and commercial banks by recapturing only that portion of the bad debt reserve corresponding to the methods that would be repealed under the President's Proposal, i.e., the experience method or the percentage of eligible loans method.

This recapture appears to be straightforward for tax purposes. However, because of the accounting method used by thrift institutions, the Proposal would have a severe impact on the financial statement and net worth of savings institutions. Savings institutions have accounted for the special bad debt deduction as a permanent difference between book and tax income. To the extent that the provision requiring recapture of the percentage bad debt deduction is enacted, the accounting profession will require that the thrift industry record a liability that would result in a charge to their 1986 financial statements by reducing net worth for the full amount of the recaptured bad debt allowance at the new effective tax rate. Although the President's proposal allows individual institutions the option of recognizing the recapture income in 1986 or deferring recognition over a ten-year period, the impact on many thrift institutions, and the industry as a whole, would be to require a current period charge against net worth far in excess of the tax revenue generated by the recapture. This would obviously reduce industry capitalization during a period when capital adequacy is an area of major industry concern.

Since the Treasury Department has not given an adequate explanation of how this recapture would work, it is difficult to provide the Committee with cost figures at this time. If the reserve is recaptured at 0.6 percent, the current percentage of loans method calculation, we estimate the tax cost to be approximately $1 billion. Nevertheless, the transfer of the funds required by recapture would be a direct reduction in net worth and could cause some thrift institutions to fall below the regulatory net worth level. This would compound the effect on the institutions and would increase the cost of recapture substantially. Whether actual payment of back taxes on this amount are spread over ten years or not, the effect on a thrift's financial statement and net worth is the same--devastating. Recapture should not be enacted as part of tax reform.

NET OPERATING LOSS CARRYOVER

The President Proposal provides for the repeal of the special net operating loss carryback rules (10-year carryback, 5-year carryforward) allowed to financial institutions. The President's Proposal provides that thrift institutions use the same carryback/carryover as other corporations. During the period since 1979, the thrift industry has experienced substantial deregulation, which took the form of elimination of controls over deposit rates and limited increases in investment authority. Unfortunately, large fluctuations in the general level of interest rates resulted in violent swings in the industry's cost of funds, while contractual long-term asset rates remained relatively unchanged. This created substantial losses for thrifts.

These deregulation losses should be available to offset future income so that surviving institutions can maximize retained earnings and capital and restore our industry to its prior strength. Present law provides an 18-year period for corporations to average income (15-year carryover and a 3-year carryback). In contrast, financial institutions are currently permitted only a 15-year period under present law (5-year carryover and a 10-year carryback).

Many financial institutions have been unable to effectively utilize their 10-year carryback since the amount of recovery was not significant in relation to the accumulated net operating losses incurred in the period of deregulation and high interest rates.

The real problem with this proposal is the transition rule. It is inequitable to convert thrift institutions to regular corporate rules but not let them use the NOL rules available to regular corporations. When the NOL carryforward was extended from 7 to 15 years in 1981, the provision was effective for losses incurred from 1976 and on.

In order to provide for equitable transition, the thrift industry believes that the President's Proposal should be modified so that existing losses are covered in the extension of the net operating loss carryforward.

REORGANIZATION RULES FOR FINANCIALLY TROUBLED THRIFTS

In 1981, Congress adopted section 597 which provided that payments made by the Federal Savings and Loan Insurance Corporation (FLSIC) to assist the merger of ailing institutions were non-taxable. The provision was introduced during the Senate consideration of the Economic Recovery Tax Act of 1981 (ERTA), and the taxability of payments made by the Federal Deposit Insurance Corporation (FDIC) to thrift institutions was simply overlooked. The payments of the FSLIC, FDIC and state deposit insurance agencies are identical. The President's Proposal now recommends that section 597 be repealed effective 1991. These rules should be clarified so that these financial assistance payments are taxed in the same manner for the period that section 597 is in effect. Otherwise, FDIC and state insured institutions will be at a competitive disadvantage to FSLIC insured institutions. There appears to be no reason to treat deposit insuring agencies and the assistance given by them differently. Regulatory-assisted acquisition transactions were structured based on the expectation that such assistance would be tax free. If the assistance were to be taxable it would change the economic value of the agreements, thereby extending the period of time it will take the thrift industry to revitalize.

CASH METHOD OF ACCOUNTING FOR TAX PURPOSES

The President's Proposal restricts the use of the cash method of accounting for tax purposes. Taxpayers would be required to switch to an accrual basis for tax purposes unless the business has average gross receipts of $5 million or less. Even businesses with $5 million or less in annual gross receipts would be required to use the accrual method of accounting for tax purposes if used for any other purpose (such as for financial statements, for credit purposes, etc.).

The stated purpose for this proposal is to more accurately match income and expenses. Nevertheless, most thrift customers are cash method taxpayers. Under this proposal, a savings institution would accrue interest income even though a cash basis taxpayer had not yet taken an interest deduction because the interest was not yet paid. This would distort the timing of, and thereby mismatch, the taxation of revenue to thrifts versus deductions by individuals. Requiring the thrift industry to adopt the accrual method would result in thrift's being required to pay tax on such income prior to collection, and in some cases, such income may never be collected on defaulting loans.

This mandatory accounting change, when combined with the elimination of the reserve method for bad debts deductions, is a double squeeze on the net worth of financial institutions. This is particularly onerous at a time when the thrift industry and federal insurance corporations are trying to rebuild capital and net worth after the economic downturn caused by high interest rates and deregulation.

CONTRIBUTION TO SPOUSAL IRAs

The President's Proposal would increase the deductible amount of contributions to spousal individual retirement accounts (IRAs) to $2,000 per year. The Council commends the President for inclusion of this measure, which would increase long-term savings and fit well with our members' mortgage lending orientation.

DEDUCTIBILITY OF INTEREST EXPENSE TO CARRY TAX-EXEMPT SECURITIES

Under current law, financial institutions have been allowed to invest in tax-exempt securities without losing their deductions for interest paid on deposits and short-term obligations. Since 1982, however, the deductible amounts invested in tax-exempt securities have been subject to the corporate tax preference cutback of 20%. The President's Proposal would further restrict this deduction.

Our tax survey shows that this provision would substantially affect a number of our members. Investment in tax-exempt securities contributed a substantial amount of income to some of our members, particularly savings banks. We have no doubt that our institutions will restructure their investments toward higher yielding taxable securities if the deduction attributable to interest on tax-exempts is repealed. We do, however, have concerns about the effect of this action on the value of tax-exempt securities currently held and would urge reconsideration of the repeal.

TREATMENT OF INTEREST EXPENSE

The President's Proposal has a variety of provisions that affect how individuals account for interest expense. First, the plan would retain the deductibility of interest incurred to carry a home mortgage on a primary home. This is, of course, an absolutely necessary provision from our viewpoint. If we are to continue to be a nation of homeowners, the deductibility of interest on home mortgages must continue. On the other hand, the plan limits the deductibility of interest paid for other consumers goods, including second homes. We do have fears over the effect of this limitation on the economy in general and in our existing consumer loan portfolios in particular. This part of the President's Proposal should be thoroughly reviewed to determine its true economical impact.

CONCLUSION

This statement has focused on specific provisions affecting thrift institutions as corporate taxpayers.

The Council is also concerned over the general economic impact of the proposed reform on budget deficits and housing. Tax reform must not add to the existing federal deficit which we believe to be the major problem facing this nation.

NFCDCU

NATIONAL FEDERATION OF COMMUNITY DEVELOPMENT CREDIT UNIONS
29 JOHN ST., SUITE 903 • NEW YORK, NEW YORK 10038 • (212) 513-7191

STATEMENT ON TAXATION OF CREDIT UNIONS

SENATE COMMITTEE ON FINANCE

September 26, 1985

Clifford N. Rosenthal
Executive Director

The National Federation of Community Development Credit Unions (NFCDCU) represents 100 credit unions which serve low-income urban and rural communities in 33 states, the District of Columbia, and Puerto Rico.

Of our current membership, only a handful would stand to be taxed under the present proposal, which sets the ceiling for exemption at $5 million. Nonetheless, we strongly endorse the positions of our colleagues of CUNA and NAFCU in urging that the tax-exempt status of all credit unions--whatever their size--be retained.

Why does it matter to our member credit unions in East Harlem or Newark, in Marianna, Florida or Tempe, Arizona, whether larger credit unions are taxed? Why do the low-income credit unions we serve--mostly with assets of several hundred thousand dollars to several million--care whether Navy Federal Credit Union or Pentagon Federal Credit Union, with assets over $1 billion, are taxed?

Because we are all part of a family. Because we are all cooperatives with the same legal structure. Because we are all providing a service, without profit, to growing numbers of the general public. And because, in a time of great turmoil in banking, that service is increasingly vital to the overall health of our nation's financial system.

Let me elaborate on this issue of service, in order to illustrate what credit unions in general--and low-income, or community development, credit unions in particular--mean in the current financial environment.

In the spring of 1984, our organization was engaged to consult on a problem which has become increasingly common in low-income areas. One of New York City's major commercial banks had decided to close a branch on the Lower East Side, which had served a low-income neighborhood for decades. In the last few years, since deregulation, it had simply become unprofitable for the bank to keep this facility open. There were too many small depositors, too few large customers. Twelve million dollars in deposits were simply not enough to keep this branch out of the red. They made a rational business decision: Close the branch.

But here is the problem. There is no other financial institution to serve the market which that bank is abandoning--a 100 square block area with tens of thousands of residents, most of them poor, many of them Senior Citizens, many of them recipients of public assistance, many low-wage working people. These people now have to spend a portion of their severely limited income on bus fares to banks in other neighborhoods and on check-cashers' fees. They have no place to save, and no place to borrow at reasonable rates.

No other bank would come into the neighborhood. None believed it was possible to make a profit.

And so, the National Federation was asked to help organize a credit union in the former bank facility. We studied the feasibility of the project, and came to understand very well why no profit-oriented institution would touch this neighborhood.

But our research also indicated that a credit union--because it is nonprofit, because it uses volunteers, because it is a cooperative, and because it is tax-exempt--can fill this gap in the banking market. Over the past year, we have worked with the people of the Lower East Side to raise nearly $1 million in deposit pledges to establish a credit union, which would provide financial services to a market which no bank wants. If the National Credit Union Administration sees fit to grant a charter, the Lower East Side Peoples Federal Credit Union will open its doors in January 1986.

There are many gaps in our banking system, and many emerging problem areas that have attracted increasing attention from Congress. We have seen a wave of branch closings and a rising tide of bank service fees. The National Federation is optimistic that credit unions would be able to fill many of these gaps, without the development of prescriptive legislation that will be resented and opposed by banks. But if Congress chooses to tax credit unions of $5 million or more, we believe it will become increasingly difficult for credit unions to play this positive role.

Our research indicates that the break-even point for a credit union offering the most basic financial services to a customer base of several thousand low-income peoples is, today, probably not less than $3 million--and this assumes a low interest-rate environment, with major sources of non-interest sensitive funds. The break-even point will approach the $5 million mark quite quickly, if high inflation and interest rates return. To provide a level of service to low-income consumers which remotely resembles that of banks would probably require closer to $10 million in deposits.

Small may be beautiful. But to be effective in addressing the problems of low-income individuals and poverty communities, to have the capacity to produce visible improvements in the face of low-income neighborhoods--a credit union must have the ability to grow larger.

Community development credit unions have learned the hard way that it is not possible to depend on government grants and handouts. We understand the problems of the deficit, and the difficulties of federal anti-poverty efforts in the past. But at the same time, we do not wish to see the federal government cripple the development of self-help, financial cooperatives, by establishing disincentives for growth.

We need more--many more--credit unions serving the people who banks can't profitably service. And we need those credit unions to grow freely, so as to achieve the economies of scale without which serving the small depositor, saver,or borrower becomes prohibitively expensive.

This movement is about mutual cooperation. Within our federation, the two largest of our low-income credit unions, with assets of $11 and $50 million respectively, have both been active in helping the smaller ones, even at some cost to themselves. And similarly, credit unions in the mainstream of American society have offered assistance to our Federation and to our individual credit unions. We hope that the Committee will see fit to encourage and nurture this process of cooperation by recommending the continuation of the present tax-exempt status for all credit unions.

Clifford N. Rosenthal
Executive Director

# # #

STATEMENT

of the

THE NATIONAL STONE ASSOCIATION
THE NATIONAL SAND AND GRAVEL ASSOCIATION
THE NATIONAL INDUSTRIAL SAND ASSOCIATION

to the

Committee on Finance

United States Senate

September 26, 1985

The Impact of President Reagan's Tax Reform Proposal on the Mining Industry

The National Stone Association, the National Sand and Gravel Association, and the National Industrial Sand Association appreciate this opportunity to present our consolidated views on President Reagan's tax reform proposals being considered by the Senate Finance Committee.

Membership in the National Stone Association is comprised of stone quarry operators throughout the United States, producing 70% of the total volume of crushed stone used in construction aggregates in this country. Our industry is the largest non-fuel mining industry in the country. The most recent Bureau of Mines report, for 1984, indicates that 950 million tons of crushed stone were produced in 48 states at a value of $3.8 billion. Our membership of stone producers is augmented by companies that manufacture mining and mineral processing equipment, machinery and supplies.

The National Sand and Gravel Association has been the recognized spokesman for the sand and gravel industry for more than 69 years. The association's membership produces a substantial majority of the sand and gravel sold annually in the United States. The most recent Bureau of Mines report, for 1984, indicates that construction sand and gravel, valued at $2 billion, was produced by 3600 companies from 5,000 operations in 50 states.

The National Industrial Sand Association was organized in 1935 and represents a large majority of the industrial sand produced annually in the U.S. The industrial sand industry is small, as measured by tonnage, when compared to other extractive industries. Many of these companies are still run by family owner-operators. The Bureau of Mines report for 1984 indicates that industrial sand valued at $370 million was produced by 97 companies from 176 operations in 35 states.

Statistics from the Bureau of Mines help illustrate the varied and important uses of aggregates. About 65% of the tonnage of crushed stone produced is used as construction aggregates, mostly for highway and road construction and maintenance, 12% for cement and lime manufacturing, 2% for agricultural purposes, and 21% for other uses. For construction sand and gravel, about 38% is used as aggregate in concrete for residential and non-residential buildings, highways, bridges, dams, and other concrete products, 22% in road bases and coverings, 17% for construction fill, 14% as asphaltic concrete aggregates and other bituminous mixtures, and 9% for other purposes. About 35% of the tonnage of industrial sand is used as glassmaking sand, 25% as foundry sand, 7% as abrasive sand, and 33% for other miscellaneous uses.

The memberships of our three association over the years have been supporters of President Reagan's economic recovery programs and we agree with the current goals set forth in the Administration's plan for tax reform --- fairness, growth, and simplicity. While we strongly support certain aspects of this tax reform proposal, among them a top corporate tax rate of 33%, we fear some components will cause irreparable harm to our industries' well being and feel that this package retreats from the capital formation provisions contained in the Economic Recovery Act of 1981.

An analysis by Arthur D. Little, Inc. for the American Mining Congress indicates that under the reform proposal by the President, the domestic mining industry would experience a significant increase in effective tax rates, while investments would decline along with employment in direct and indirect mining industries.

We consider the strength of our three industries intrinsic to our nation's continued economic well being. Basic and fundamental characteristics of our industries are high risks, cyclical prices, large investments, and long lead times to bring new mineral deposits into production. Decades of effort and huge financial expenditures present challenges to our industries that many others do not confront. The present tax code recognizes these characteristics and offers a variety of incentives upon which the mining industry has come to rely and plan. Foremost among these incentives, and certainly unique to the extraction of natural resources, is percentage depletion.

Although the method of calculation for the percentage depletion allowance has been revised, and its merits debated through the years, Congress has for over three decades repeatedly endorsed the basic concept of special treatment for depletable assets. The depletion allowance has become an integral part of the economics of our industries and its maintenance is necessary to avoid serious dislocation. Industrial and economic development is often critically affected by the availability of aggregates.

Mineral resources are "wasting assets" and they are therefore non-renewable. To meet our nation's needs---both public and private---new mineral reserves must be found and developed constantly. Percentage depletion helps make possible that expansion. Congress in the early 1950's expanded the then existing depletion allowance to include the important minerals produced by our industries. In the Mining and Minerals Policy Act of 1970, the Congress recognized that it was our national policy to foster and encourage private enterprise in the development of an economically sound domestic mining industry, and in the orderly and economic development of domestic mineral reserves. Tax reform should not alter this successful mineral policy, nor should reform inadvertently debilitate certain industries. We fear this is likely with the adoption of the Administration's tax reform proposal with respect to percentage depletion and believe its elimination will seriously impede the growth of the domestic mining industries. Collectively, we estimate that our three industries will incur costs of over $300 million annually should percentage depletion be repealed.

Our industries need the incentive offered by percentage depletion in order to develop and produce marketable products efficiently if we are to grow and meet the continuing demand for minerals basic to the construction needs of the nation. That demand is ever-increasing with the building and rehabilitation of our nation's roads, highways and infrastructure. Any decline in our industries' ability to meet these needs will negatively impact our nation's construction industry, and, ultimately, our economy as a whole. While the companies which make up our industries may not have the luxury of being "household names", we are an integral part of everyone's daily life. Aside from the obvious interplay we have with the construction industry, natural resources---along with our nation's agriculture---provide virtually all the raw materials supplied to manufacturing and processing plants. While we may be considered "behind the scenes", our products provide a foundation which is vital and real to all aspects of society.

We strongly believe that it is counter-productive to assault needed tax incentives which have historically proven their worth. Depletion, for mining, like depreciation, for all businesses, is an ordinary and necessary business expense. In both cases, the taxpayer is allowed a deduction in recognition of the fact that an asset---in the case of depletion, the aggregate reserve itself---is being consumed.

The revenue gain purportedly to be generated for the Federal Treasury through the proposed five year phase-out of percentage depletion for all extractive industries is \$2.1 billion. However, the amount of revenue gained from our industries alone would be relatively insignificant and out of proportion to the negative impact of percentage depletion's repeal. Mining is a capital intensive industry with adequate cash flow being imperative to our industries' financial stability. The percentage depletion allowance often accounts for that necessary cash flow. Even a small reduction in cash flow can mean the difference between continued production or abandonment of a mining operation.

The repeal of percentage depletion would inevitably result in higher costs of operation. These higher costs would either be passed on to the consumer or necessary exploration and development activity would have to be reduced. Many deposits now held in reserve may not be deemed economical to mine. We already are experiencing a mineral shortage, particularly in urban and suburban areas where zoning laws have restricted minerals' availability. Generally, it is uneconomical to transport minerals of our industries great distance. Adding an additional financial burden through changes in the tax code will either increase costs further or exacerbate those shortages.

The elimination of percentage depletion in our view is not based on sound economic judgement. Rather, it appears to be based on the need to satisfy the perceived public concern with respect to certain oil and gas tax preference items. In maintaining percentage depletion for only small oil and gas wells, the Administration seems to have ignored the very real value of percentage depletion to other extractive industries.

Our industries are generally composed of small-to-medium sized operations with modest profit margins. Only recently have many of our operations begun to experience the economic recovery that other industries in our nation have enjoyed for several years. Some producers who were crippled by the recession may never recovery fully if they are stripped of the percentage depletion allowance, the investment tax credit, the expensing of exploration and development costs and the accelerated cost recovery system.

Our three industries are extremely capital intensive. Equipment necessary to quarry and process minerals is very costly. Without the benefit of the investment tax credit, the average mining operation would not be able to replace its plant equipment often enough to benefit from technical and safety-oriented engineering advances. Maintenance costs on older equipment would rise sharply and the economic viability of many operations could soon be in jeopardy. This has already been the case with other capital intensive industries. The investment tax credit is a necessary economic incentive not only to us, but to all capital intensive industries. It was first proposed by President John F. Kennedy and subsequently reindorsed by President Reagan in his 1981 tax bill. It has proven over the years to be an effective economic stimulus critical to the revitalization of the country's industrial base.

In addition to percentage depletion and the investment tax credit, we would like to briefly address other components of the Administration's tax reform proposal that would negatively impact our industries.

We oppose the Administration's plan to classify as a preference item 90% of the deductible portion of mining exploration and development expenses, and subject this amount to the proposed alternative minimum tax. We note that research and development costs are not included in the Administration's proposal to be taxed in this manner. To our members, exploration and development costs are our R&D. This, we feel, will be an unfair burden and creates still further reductions in cash flow.

The plan to replace the current accelerated cost recovery system (ACRS) with the capital cost recovery system (CCRS) can only further retard capital formation. The CCRS adds a new dimension of complexity to the depreciation of assets with no identifiable advantage. ACRS has proven to be efficient and an effective stimulus for economic growth and therefore should be retained.

Our associations have consistently opposed the establishment of a minimum tax and therefore continue to oppose any effort to further expand this pernicious tax item. Noted economist Paul Craig Roberts, writing in Business Week, May 6, 1985, indicated that a corporate minimum tax has in the past decreased mining output.

We also associate ourselves completely with the position of the Associated General Contractors and other groups opposed to changes in the completed contract method of accounting.

We hope the Senate Finance Committee will take these formal comments into consideration as final tax reform legislation is drafted. We look forward to working with Congress and the Administration to fashion a tax reform bill that provides real simplicity and equity without sacrificing capital formation provisions of the existing code that are critical to the economic recovery of our nation.

BEFORE THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

THE IMPACT OF PRESIDENT REAGAN'S TAX REFORM PROPOSAL ON FINANCIAL INSTITUTIONS AND ON THE MINING INDUSTRY

(HEARING DATE: THURSDAY, SEPTEMBER 26, 1985)

WRITTEN STATEMENT
OF THE
WESTERN COAL TRAFFIC LEAGUE

Dated: October 10, 1985

BEFORE THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

THE IMPACT OF PRESIDENT REAGAN'S TAX REFORM PROPOSAL ON FINANCIAL INSTITUTIONS AND ON THE MINING INDUSTRY

(HEARING DATE: THURSDAY, SEPTEMBER 26, 1985)

WRITTEN STATEMENT OF THE WESTERN COAL TRAFFIC LEAGUE

This statement is submitted on behalf of the Western Coal Traffic League ("WCTL") in connection with the Committee's consideration of the impact of President Reagan's Tax Reform Proposals on financial institutions and the mining industry.

WCTL is a voluntary association formed in 1976 to represent the interests of its members before the Congress, the courts, and agencies of the federal government in matters related to the acquisition and transportation of bituminous coal. Its members are identified in Attachment A to this Statement. The common interest between its member organizations is that each is a major utility or industrial shipper and consumer of bituminous coal mined from sources west of the Mississippi River. WCTL's membership is a diverse one which includes municipalities, industrial corporations, public districts and utilities of all types. Collectively, its members consume almost 75,000,000 tons of bituminous coal annually. The lion's share of this enormous consumption comes from Western producers who supply coal to WCTL members under long-term agreements, whose minimum terms are about 10 years.

While several provisions of the President's Tax Proposals for Fairness, Growth and Simplicity will have a substantial financial impact on the coal industry -- and those segments of the economy which rely upon it -- in general, the issue of primary concern to WCTL's members as consumers of coal is the proposed repeal of percentage depletion allowances. Elimination of the depletion allowance would impact directly on electricity consumers and taxpayers in the form of increases in fuel costs which would result from the additional tax liabilities coal suppliers would be required to bear. A recent study of the economic effects of the tax reform proposals on the coal industry suggests that repeal of percentage depletion will cause in excess of $900 million in additional tax liability for the coal industry -- a cost which will be passed on in one way or another to utilities and other coal users.1/ In light of these facts, WCTL urges this Committee to consider the hardship that additional tax liability of the magnitude proposed would cause for coal purchasers, and for the ratepayers and customers of these coal consumers who must ultimately absorb such increases.

1/ Price Waterhouse, The Economic Impact of the President's Tax Reform Proposals On the Coal Industry.

WCTL's principal objections to the proposal to repeal percentage depletion allowances for coal producers may be grouped into three basic categories, each of which will be addressed below: the direct impact on future fuel costs, the indirect impact on coal prices as a result of a reduction in competition, and the conflicts between the depletion allowance proposal and national energy policy goals.

As noted above, much of the coal in the West is marketed pursuant to long-term purchase agreements. Although most WCTL members and other utilities depend upon long-term agreements for their base fuel requirements, most utilities also obtain large quantities of coal each year on the so-called "spot market." The need for spot coal arises as a result of many causes, including interruptions in production by the long-term supplier, increases in peak electrical load demand necessitating purchase of incremental fuel above contract levels, short-term supplies during periods of resourcing or renegotiation, etc.

The prices that a utility pays for spot coal are unprotected; that is, they are subject to the vagaries of the market place. In general, spot coal prices are set on a full cost recovery basis; the producer establishes a price sufficient to cover all costs and taxes, plus generate a return sufficient to justify investment in fixed plant facilities, etc. An increase in taxes naturally reduces the producer's return, and must in turn result in a direct increase of the mine mouth price if the producer is to maintain its prior level of profitability.

One immediate result of the proposed repeal of depletion allowances, therefore, will be a likely increase in spot coal prices to utilities and other coal receivers, in a magnitude equal to the hundreds of millions of dollars in additional taxes which the repeal will mean for coal producers.

The direct coal price impact is not limited to spot coal, however. While the effect may not be universal, it is also the case that many coal receivers will feel the effects of percentage depletion repeal in the prices which they pay under long-term supply agreements.

Many long-term coal contracts are confidential and/or proprietary documents, and therefore their terms cannot be revealed publicly. Several of WCTL's members, however, are public or municipal entities, whose coal supply agreements are in the public domain. One example illustrates how many long-term agreements will automatically require buyers to absorb any and all additional tax liability caused by a reduction in the federal percentage depletion allowance. The following is excerpted from a contract to which the City of Austin, Texas and the Lower Colorado River Authority are signatories:

> The price of coal delivered hereunder shall be increased or decreased from the Base Price in the same amount that the cost per ton of mining coal at the Mine is increased or decreased by new, additional or reduced taxes (or changes in the rates of said taxes) of any kind whatsoever, enacted or effective after March 31, 1974. This provision shall not apply to costs relating to (1) state or federal taxes on net income (excepting that a reduction in the federal percentage depletion allowance shall be deemed to be an increase

> in cost within this provision), (2) taxes specified in Section 9.03, and (3) transfer taxes provided for in Section 9.07. (emphasis supplied.)

This section clearly reveals how the buyer's price for each ton of coal acquired under contract is directly affected by a change in the amount of the federal percentage depletion allowance. As an adjustment in the cost of fuel, such cost increases would, in turn, be passed through to the utility's ratepayers.

Like the big oil and mining companies, WCTL's members, in most instances, pass increases in their coal prices on to the electric consumers. Most of the member companies operate in jurisdictions where fuel cost increases are immediately and directly added to the customer's bills. A few members must first secure regulatory permission to pass on the royalty increases. Invariably, however, whatever the regulatory arrangements are, the individual electric customers would pay the additional tax liabilities incurred as a result of a repeal of the percentage depletion.

The second area of major concern to WCTL and its members is the long-term effect on coal prices which percentage depletion repeal could have as a result of its impact on competition in the coal industry.

Coal mining is one of the most fiercely competitive industries in the United States. Today, for a variety of reasons, the coal market is very soft, with low prices maintained by an effective competitive balance among many concerns involved in the industry. Not all of these companies, however, are on sound financial ground, and many are currently operating at or near the margin. Indeed, it is quite likely that for a number of companies presently engaged in the production and sale of coal, the deductions in gross income made possible by percentage depletion -- and thus, the resultant reduction in income tax liability -- may mean the difference between net profit and net loss on an operating basis. An elimination of percentage depletion, with the resultant increase in tax liability to coal producers, may push such companies into the red, and result in a net reduction in the number of producers participating in each market.

In the West, repeal of percentage depletion can be expected to have a retarding effect of the opening of new mines, the expansion of existing mines, and the exploitation of new leaseholds, in addition to the more drastic impact of a genuine reduction in the number of coal companies in the marketplace. The result of these developments, of course, would be a reduction in the rate of supply and a contraction in the number of competitors vying to meet user demands. The combination of these two forces most assuredly will produce higher prices over the long-term, prices which -- as noted above -- will be paid in the first instance by utilities and other coal users, but ultimately will be borne by electric ratepayers and consumers.

Finally, WCTL submits it would be contrary to the declared national policy of encouraging private development of domestic energy sources in an economically sound environment and the promotion of independence from foreign fuel suppliers if

Congress were to adopt tax modification proposals which would have the effect of imposing such significant additional costs on the U.S. domestic coal industry. Without exception, WCTL members in the past burned huge amounts of natural gas and oil in their operations. WCTL members were encouraged -- indeed, frequently compelled -- in the national interest to convert from scarce oil and gas to abundant western coal. This encouragement came largely from the federal government, which was deeply concerned over the nation's energy crisis during the early 1970's. The goal was to ensure a stable, long-term supply of domestically produced energy at a reasonable cost. WCTL members committed millions of dollars of capital to the construction of new coal-fired plants, to fleets of railroad cars, and, in some cases, to coal mining equipment. These enormous capital outlays were matched by massive investments by domestic energy companies in new coal leases and development facilities, all in the interest of the national goal of energy independence so forcefully pursued through the 1970's.

By following the President's percentage depletion proposal and dramatically increasing tax liabilities, however, the Congress would in a sense be reneging in the bargain which it made with domestic energy producers and users in the 1970's. It is demonstrably unfair for the federal government to exploit coal producers and consumers when it was the federal government which either required or encouraged most of these same interests to turn to U.S. coal in the first place. The removal of established tax incentives would place U.S. mining firms at a new disadvantage compared with foreign producers that are wholly or partially owned, operated or subsidized by foreign governments which can easily increase production, in many cases based on their need for foreign exchange and employment rather than on the free-market economics of supply and demand.

For the several reasons discussed above -- which are admittedly but a part of the serous problems facing coal-dependent electric suppliers and users under the proposed tax reforms -- WCTL respectfully urges the Committee to weigh the effect of the President's proposals on coal producers, and ultimately on consumers and to maintain the depletion allowance for the coal industry.

ATTACHMENT A

MEMBERS

WESTERN COAL TRAFFIC LEAGUE

Arizona Electric Power
Cooperative, Inc.
Benson, AZ 86502

Celanese Chemical Company
Dallas, TX 75247

Central Louisiana Electric
Company, Inc.
Pineville, LA 71360

Central Power & Light
Corpus Christi, TX 78403

City of Austin
Austin, TX 78767

City of Colorado Springs
Colorado Springs, CO 80947

City Public Service Board
San Antonio, TX 78296

Iowa Public Service Company
Sioux City, IA 51102

Kansas City Power & Light
Kansas City, MO 64105

Kansas Power & Light Company
Topeka, KS 66601

Lower Colorado River Authority
Austin, TX 78767

Minnesota Power & Light
Duluth, MN 55802

Oklahoma Gas & Electric
Oklahoma City, OK 73101

Omaha Public Power District
Omaha, NE 68102

Tuco, Inc.
Amarillo, TX 79106

Unitrain, Inc.
Des Moines, Iowa

Utility Fuels, Inc.
Houston, TX 77046